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THIRD WORLD DEBT PROBLEM

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL DEBT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

APRIL 6, 1987

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THIRD WORLD DEBT PROBLEM

MONDAY, APRIL 6, 1987

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL DEBT,
COMMITTEE ON FINANCE,
Washington, DC.

The committee was convened, pursuant to notice, at 9:35 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Bill Bradley (chairman) presiding.

Present: Senators Bradley and Durenberger.

[The press release announcing the hearing follows:]

INTERNATIONAL DEBT SUBCOMMITTEE CHAIRMAN BRADLEY ANNOUNCES HEARING ON FINDING SOLUTIONS TO THE THIRD WORLD DEBT PROBLEM

Washington, DC.—Senator Bill Bradley (D., New Jersey), Chairman of the Finance Committee's Subcommittee on International Debt, announced Monday that the Subcommittee will hold a hearing on Monday, April 6, 1987, at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building to ascertain what principles for managing Third World debt can encourage meaningful growth-oriented reform in borrower countries, reverse the outflow of resources from developing countries to industrial countries, support the efforts of developing democracies to combat poverty, achieve balance in North-South trade, revive U.S. export markets, and restore confidence in both debtor economies and creditor banks. The issues for this hearing are:

(1) Whether current Third World debt management policies promote debt crises rather than debtor reform.

(2) Whether bridge loans undercut debtor economic growth.

(3) Whether bridge loans result in overstated bank profits.

(4) Whether major Third World debtors have anything more to lose when creditors threaten to withdraw credit.

Senator **BRADLEY**. The hearing will come to order. In the last hearing, we heard from a number of people who spoke about how the debt crisis affects various sectors of our economy.

At this hearing, we will hear some Congressional testimony, in particular I am very pleased that Senator Paul Sarbanes, who refined and developed a very important approach to this problem, will testify. We are also fortunate to have witnesses with backgrounds in national security, investment banking, political science, law, economic reporting, and commercial banking.

My hope is to find some broad principles for a long-term strategy to deal with the debt crisis. Our debt management policies today basically provide emergency loans in response to indebted developing country payments crises.

Creditors respond more and more to payments crises and less and less to the serious attempts by some indebted developing countries to institute economic, political, and social reform. But meaningful reform can entail high political costs, and it is not easy for any leader to overhaul tax collection, to reorganize an economy, to shift the division between public and private works, to reform trade and investment policy, currency convertibility, and government control over money and banking.

Leaders that take political risks to make these changes need prompt and convincing support from their foreign creditors. If we seriously believe the hope for mutual growth centers on debtor reform, we have to honestly ask whether our actions encourage reform or promote crises and confrontation. If banks really believe, as I do, that we must follow a case by case approach, then we can show generosity to those debtors who show courage and conviction. How can we encourage banks to take this long-term view?

Developing country debt is now so large that the payments problems are endemic. Putting aside some of the complex new options under discussion, let's focus on the basics. Broadly, creditors can handle a shortfall in any given year either by forgiving the amount of interest that a debtor cannot afford to pay, or lending it the emergency money it needs for the payment in full. This is the choice between interest relief and new money. Emergency lending that finances interest payments increases debt but builds no new factories.

Do emergency loans undercut economic growth of the borrowers? Since emergency lending raises the level of debt, some people claim it can erode investor confidence, fuel capital flight, and create a political climate hostile to serious economic reform. A number of economists, political scientists, and political risk analysts argue that most Latin American countries are now so sensitive to debt that debt will stifle their growth.

We offer such countries no alternative to recession through austerity if they tighten their belts to pay; a recession through loss of confidence if they borrow to pay. If this is a real problem for some countries, then the Baker plan, despite its excellent intentions, will help neither them nor us in the long run.

If emergency loans stifle the very growth we want to promote, that leaves us only the options of granting relief or facing the inevitability of a succession of defaults.

Banks point out that interest relief reduces profits while bridge loans do not. But interest relief does not reduce bank cash flow or the quality of land portfolios. What justifies the great profitability of bridge loans?

Finally, many people argue that interest relief or debt forgiveness would harm indebted developing countries by making it more difficult for them to borrow in the future, but most major developing country borrowers believe they have already lost access to the credit market. Aren't future investments in developing countries more related to the prospects for economic growth in those covntries?

Under current circumstances, what more do major borrowers really have to lose? I look forward to the guidance that we will receive from today's witnesses, and I am particularly pleased that our opening witness will be Senator Paul Sarbanes of Maryland, who has developed and is continuing to refine a plan for a facility to acquire trouble Third World loans in a manner that can deliver both relief and hope to the developing nations. Senator Sarbanes, welcome to the committee. It is a pleasure to have you here, and we look forward to your testimony.

STATEMENT OF HON. PAUL SARBANES, U.S. SENATOR FROM THE STATE OF MARYLAND

Senator SARBANES. Thank you very much, Mr. Chairman. I appreciate this opportunity to appear before your subcommittee to discuss the issue of Third World debt. It is very appropriate that the Finance Committee should have a major interest in this issue since the way in which the debt crisis is managed has major implications for U.S. economic growth and U.S. international trade, both of which are, of course, major issues which the Finance Committee must address.

Also, Mr. Chairman, I want to underscore the contribution that you have made on this important issue in placing it on the public agenda and opening a very important dialogue on the matter. I will be relatively brief this morning because I know you have two panels yet to come.

The nature of my remarks can be summarized briefly in four major points. First, the world economy is seriously distorted by problems of associated with Third World debt. Current strategies for managing the debt problem have resulted in severe import compression in the developing countries, with an attendant slowing in export and GNP growth in the industrialized world.

Second, the debt overhang is draining financial resources from the developing world, cutting back on growth and creating serious economic and social problems in a region of the world which is of vital economic and strategic importance to the United States. I want to take just a moment on that point.

In many of these countries, we have an emerging democracy, after years of authoritarian totalitarian rule. That is obviously a development that is very much to be welcomed, very much to be sought after; but I have serious concerns that if we continue to press them as hard as they are now being pressed economically, whether these emerging democracies will be able to sustain themselves.

Third, existing approaches to managing the world debt problem appear to be inadequate to the task. Although a major financial crisis associated with the debt problem has not yet occurred, crisis avoidance is hardly a sufficient indicator of future success. Better ways must be developed to combine management of the old debt with an expansion of growth and trade in the developing world.

And finally, better management of the debt crisis will require us to confront the reality that, in effect, in the past mistakes were made. We need to recognize this, both in the private sector and by governments. At banks, lossess will have to be accepted in a balanced and equitable manner if we are going to move forward to an effective resolution of the problem.

I have provided to the committee some charts in my testimony which illustrate the evolution of the debt problem and the challenges it poses for international economic policy.

Mr. Chairman, with your permission, I will move through them very quickly. I think you have them before you.

The first, which shows debt to GDP ratio of the 15 Baker Plan countries—and I have used those for purposes of illustration, although there are many others—indicates that there has been little improvement in the debt burden. As you can see, debt to GDP ratio has gone from 30 percent in 1978 to almost 48 percent in 1983, and is still up at about 46 percent. So, there is a very sharp rise in debt to GDP ratio.

Second, the cessation of voluntary bank lending has shifted the resource transfer equation sharply to the disadvantage of the debtors. And you can see there the net resource transfers; and again, it is very clear with this very sharp line how it has shifted to the disadvantage of the debtors. And you can particularly notice the movement of the new borrowing line, and it has been its reflection in the region of the transfer line.

Exporting resources has led to a sharp decline in investment in the debtor countries. As you can see, there is a very sharp drop in capital formation as a share of GDP in these 15 Baker Plan countries.

Obviously, then, falling investment has helped depress growth in the debtor countries, and we have here a per capita real GDP index. And once again, you can see the pressure that is being put on these debtor countries, particularly when you are talking about sustaining a democratic evolution by this sharp drop in per capita real GDP index.

Debt is a problem for the world economy as well. Export promotion programs help drive down commodity prices; and that is reflected in this table that indicates primary commodity prices. One of the things that happened of course is that, when you had this austerity program imposed on the debtor countries, they stopped taking exports from the industrialized countries, but they also sought to maximize their own exports.

Of course, one of the things that happened was that, while the volume of their exports increased, the value of it did not increase because they were pushing so much into the market in order to try to meet this earning problem and that was part of the reason that prices fell. Volumes went up, but the earnings from the increased volumes did not markedly change. Debt servicing pressures have required a dramatic shift from deficit to surplus in trading accounts of debtor countries, and that is reflected in this next table, which shows the trade balance in U.S. dollars of the 15 Baker Plan countries, and you can see the very dramatic shift which has taken place from deficit to surplus in those trading accounts.

The U.S. market has provided most of the new export revenues needed to pay debt service. This is Latin American exports to major countries, and we use Latin America because, in many respects, the debt problem as we are discussing it is centered in Latin America. They constitute a very large majority of the countries in the Baker Plan.

And here you can see what the U.S. has been taking in terms of these exports from Latin America—a very sharp increase. Of course, we have two lines to compare with Japan and Germany, what they have been doing with respect to taking Latin American exports, which show not very much of a rise.

That, of course, is our traditional trading area, but nevertheless, I think those lines are very indicative.

The next chart shows how our own trade with debtor countries in Latin America has deteriorated during the debt crisis. As you see, the imports have moved up sharply. That was reflected in the previous table; but you see what has happened to U.S. exports and that growing gap between U.S. imports and U.S. exports in our trade with Latin America, which of course represents a departure from historical precedence, as indicated by the way the lines tended to coincide in earlier periods.

The key debt service ratios in the debtor countries are worsening. We have the debt to export ratio, which indicates that very clearly. Now, Mr. Chairman, I have moved through those charts rather quickly, but I think they portray a problem which has not markedly improved, despite five years of concerted effort by the major industrialized countries to manage it. The initial strategy of coping with the collapse of external lending through IMF mandated austerity failed to achieve success and has been replaced with a new strategy, the Baker Plan, designed to speed up growth in the debtor countries by providing substantial new public and private lending.

The emphasis on growth in the Baker Plan is a welcome new development, and I commend the Secretary and did so at the time for shifting the emphasis away from austerity, which offered no hope really—no hope whatever—to at least an effort to introduce the concept of growth. But there is substantial concern about the mechanisms which are part of the plan, about whether they are adequate to the task of restarting growth in the developing world.

The first problem is one of scale. The sums mentioned by Secretary Baker are too small to provide the external finance needed to restart the growth process in the debtor countries. At present, the 15 countries mentioned in the Baker Plan are paying approximately $40 billion per year in interest payments on their old debt and receiving less than $10 billion in new capital flows from official donors and private investors. This means a net outflow of financial resources of some $30 billion per year.

The plan would reduce the yearly outflow by about $9 billion, leaving the poor countries as substantial exporters of capital at a time when more domestic investment is needed for their growth.

The second problem is perhaps one of concept. The plan provides new resource flows through additional lending at a time when debtor countries are already burdened with an unsustainable amount of debt. As the following chart suggests, key debt service ratio for the 15 Baker Plan countries has deteriorated over the past several years rather than improve. This raises some questions about the willingness of both banks and debtors to add more debt to an already excessive external debt burden.

And the third problem is one of practicality. It is proving difficult to persuade the commercial banks to come up with the money to fund new and voluntary lending packages. It has taken more than a year simply to negotiate a loan agreement with Mexico, and disagreements among the banks continue to block final agreement on the package. Many commercial banks have indicated their objections to more "forced" lending, and it would seem likely that this resistance will only increase in the future.

Let's talk a bit about a new approach to the debt problem.

It is possible that the world economy could continue for a while with the current set of policies to manage the debt crisis. But prudence suggests the need to develop new solutions to the debt problem, solutions which would help reduce the debt burden on the developing world rather than increase it.

Such a new approach would, I believe, require coming to grips with the problem of the old debt, and we have a chart here that indicates the reschedulings—the multilateral debt reschedulings—which have taken place between 1975 and 1984. As you can see, the number has just increased almost astronomically. Adding new debt to the balance sheet of a troubled borrower is rarely the route of choice for banks in dealing with the domestic corporations. The preferred method is generally to restructure the company and accept some losses on the old debt so that the enterprise can get back on its feet as a going concern in the future.

To apply this analogy to the international scene would require banks to recognize that some of the existing debt is excessive and beyond the capacity of the borrower to repay. Recognizing these losses would help clear the way for a swift recovery in the debtor countries and set the stage for more responsible debt financing in the future.

In recent months, it has become apparent that a significant number of banks are willing to contemplate this type of loss recognition. Loans to debtor countries are being traded in the secondary market at deep discounts from their face value.

Each sale at a discount represents a recognition of losses on past debt and the rising volume of secondary market sales clearly suggests a growing bank willingness to accept these past losses.

What, it seems to me, is missing is an effective mechanism for translating the losses experienced by the banks on discounted loan sales into equivalent gains for the debtor countries. A loan sold at a discount to a speculator, for example, produces a higher rate of return for the speculator but leaves the debtor country saddled with the same debt burden as before. In other words, a number of banks are taking the loss, discounting the loan; but then that discount does not pass through to the debtor country. It goes in the hands of someone who obviously is assuming the loan on the speculation that they will be able to require if not its full face value, certainly more than what it cost them to acquire it.

Some contemporary mechanisms, such as the debt-for-equity swap, make use of the secondary market to extinguish old debt and replace it with equity. This may under certain circumstances produce a financial advantage for the debtor country, but this is by no means guaranteed by the simple act of converting debt into equity. In any case, the market for debt/equity swaps appears too small to come to grips with the full size of the debt overhang.

Existing secondary market activities could be substantially enhanced by the creation of an intermediary which would manage the process of converting bank loss recognition to discounted loan sales into improved debt service positions for the borrowing countries. The House Banking Committee has already marked up legislation which moves in this direction by calling for the creation of an international debt management facility.

Such an intermediary would make a greater range of options available to banks for responding to the debt crisis. It would certainly not preclude new bank lending in situations where additional debt seemed justified by commercial considerations. In situations where additional lending was not prudent, however, the existence of an intermediary would create a way of providing equivalent resource transfers to the debtor countries through loss recognition on old debt.

By offering the opportunity for voluntary loss recognition to banks and countries, an intermediary could improve the flexibility and capacity of the international financial system to manage concurrently both the debt and the growth problem.

The creation of some intermediary institution would help to further important U.S. interests at stake in the debt crisis. Specifically, the U.S. has four key interests which could be furthered by such an intermediary.

One, foreign policy interests. As I indicated earlier, the U.S. should be strongly supportive of trends toward democracy in the Third World. Sustaining those democracies requires economic growth and stability, both of which could be furthered by a debt-reducing growth strategy managed through such an intermediary.

Second, safety and soundness of American financial institutions. Thus far, banks have largely avoided loss recognition on loan assets which are heavily discounted by private financial markets. As a result, they appear to be sounder than they really are, less prepared for the possibility of future loss or default on these loans. The safety and soundness of the system, the accuracy of financial disclosure would be enhanced by improved mechanisms for loss recognition on existing Third World debt.

Third, U.S. trade. Estimates vary about the negative impact on U.S. trade which debt-induced austerity produced. There is, however, no doubt that imports have been severely depressed in most debtor countries for the past several years.

And fourth, global economic stability. The U.S. remains the world's largest economic power and bears the leader's usual burden of having to be concerned about the well-being of the international system as a whole. Producing an orderly adjustment by the world economy to a declining American trade deficit will require substantial market growth elsewhere in the world economy. At the same time, mechanisms must be found to encourage the reduction of trade surpluses in certain chronic-surplus countries. Both goals require a better process of channeling financial resources from surplus to debtor countries than is currently in prospect. The kind of financial intermediary currently under discussion could provide an effective institutional mechanism for the productive recycling of capital from surplus to debtor countries.

Mr. Chairman, Congressman Obey and I back in November wrote an article which appeared in The New York Times on recycling surpluses to the Third World, and I would like to submit that for the record as well.

Senator **Bradley**. By all means, it will be submitted for the record.

Senator **Sarbanes**. Thank you very much for this opportunity to testify.

Senator **Bradley**. Thank you, Senator Sarbanes, for your testimony and also for your enormous contribution in this area. You are extremely well situated on the Banking Committee and the Foreign Relations Committee, and your interest and intelligence in this area is really, I think, an important leadership role. Let me ask you this. The real question is: If we come to our side of the table—meaning developing countries—with some form of debt or interest rate relief, some form of giving a break to Third World countries, what do you think their responsibility is in terms of getting their own economy moving?

Senator **Sarbanes**. Oh, I think they carry a heavy responsibility in that regard; and I would expect, if you established an intermediary facility, which would be a multilateral institution—and in some way involved with the World Bank and the IMF—that you would have to have as any part of its discounting of the debt and passing those benefits on; and also they could, of course, help to restructure the balance of the loan burden. And I think it is reasonable to assume that it would be at better rates and better terms, so there would be some benefit gained from that as well; but it ought to be part and parcel of an economic program on the debtor countries which offer the prospect of getting them on a stable growth pattern that can be sustained.

It seems to me that one of the things you need is to put all of this into a more comprehensive framework. You need, in effect, to say: Here is a scenario that has been worked out which is reasonable in its premises, and if it develops according to the way it has been projected, it is going to enable growth to take place, enable you to move out of this economic situation. But there is obviously a heavy burden on the debtor countries, and some of the policies which Brazil followed over the course of the last year to 18 months dramatically illustrates that.

Senator **Bradley**. So, you think that debtor countries have a responsibility for their own internal economic policies to make sure that they have some chance of growth if given some relief?

Senator **Sarbanes**. That is right. It is a little bit like riding a bicycle. You have to get a certain amount of speed going on the bicycle; otherwise, it is going to wobble all over the place. So, the speed in this instance is equivalent to growth. You have to have some growth so the bicycle can move forward. On the other hand, the bicycle can't get revved up so fast and be moving so quickly because then there is a danger inherent in that as well.

So, you have got to get a reasonable program moving, and there is a heavy responsibility, I think, on the debtor countries to do that.

Senator **Bradley**. You point out that many of the banks are already selling their loans in the secondary market. There are some proposals that simply require broad reserving, making no distinction between loans for payment of interest and loans for growth. My question to you is: Do you think that broad reserving is a reasonable way to go here? Because the real question is: How does the debtor get the benefit of broad reserving of the bank? The bank might indeed be more stable; but as I understand your proposal, what you want to make sure of is that a debtor country gets some relief so they have some prospect of growth?

Senator **Sarbanes**. It is a tricky question because you need to address this financial soundness question, and you need to get the balance sheet of the banks to a more accurate framework. To the extent that they are required to increase their reserving, it might move them in the direction of being more willing to discount the existing loans since they have already reserved against them.

But the point you touch on is, of course, critical. Even if all of that happens, there is, at the moment, no mechanism for transferring that through so that the debtor country gets some relief from this overhang of debt that enables it to move onto a growth pattern. And unless it can move on to a growth pattern, then you will continue to have very serious questions about its ability to handle even the remaining debt that it has, its ability to sustain democracy, and the whole international trade and economic stability question.

In effect, what has happened is in a sense our manufacturers and producers have been crowded out, so to speak. The programs imposed in order to meet the financial obligations have worked to the marked disadvantage of our producers, both those who export into these countries and other producers who then confront a much more intense competition from the producers in the Third World seeking to maximize their own exports. We get hit twice. We lose our exports and we have more intense import competition.

Senator **Bradley**. Yes. It sounds to me like you have some broad principles that are involved in your own thinking about this, such as; first, the debtor country has a responsibility to make some internal reforms; second, that any benefit that accrues from a restructuring should flow through to the developing country; and, third, that you have to be aware of the U.S. banking system and its soundness as you begin to make these judgments. Would that be a fair characterization?

Senator **Sarbanes**. Yes, it would be. I think there are some tough practical problems involved with an intermediary, and I don't minimize them, although I don't think it is up to us necessarily to work out every detail. That needs to be worked out, in effect, in the international arena. It would also involve, first, how it is going to be funded.

In The New York Times article, we suggested that the countries running very large current account surpluses, which would be Japan and West Germany currently, carry the special responsibility in this regard, to recycle those surpluses. And I would argue they do it multilaterally. They are doing some of that bilaterally, particularly Japan, but then to tie it into the trade.

Second, you have some question on how you do your discounting. I mean, you have a secondary market, but that gives the largest discount to the worst actor. That runs at cross purposes with the point we were just making about the need for the developing countries to have a set of coherent economic policies themselves.

We would have to give some consideration to how you would address that question.

And then third, while you would hold out the prospect that the banks come in voluntarily, you would have to look at the question of, in effect, something approximating across the board participation. Otherwise, a lot of banks are discounting; a bank can stay out and not discount. Its position then becomes strengthened in terms of recovering because of the discount that the other banks have taken.

So, all of those are fairly tough practical questions that have to be addressed.

Senator **Bradley**. Just one last question. The executive branch has more levers on this issue than does the legislative branch, but do you feel that if the executive branch continues to follow a policy which is broadly viewed as being contradictory to growth and to increasing the chance for sustained democracy, that the legislative branch simply does have an important role to play here in charting a direction on this issue?

Senator **Sarbanes**. Oh, I think so. I think that, in a way, although we weren't in a position to call these kinds of hearings in the last six years, but hearings during that period which had focused on this debt overhang and also hearings which would have focused on the overvaluation of the dollar might well have served to head off, impede, or even prevent this incredible deterioration of the U.S. position internationally.

I mean, we have gone from being the world's largest creditor nation to the world's largest debtor nation in five years. We have run this very large trade deficit—very sharp, steep increases in the——

Here is a chart that shows the U.S. trade deficit. And as you can see—this is 1982 here and this is 1986 here—and you can see the very sharp rise in the U.S. trade deficit. And of course, the other side of that coin is the decline in the net asset position of the United States. I mean, here we are up here with a very positive net asset position—almost $150 billion in 1981—and here we are in 1986 approaching a $250 billion deficit in our net asset position. Now, that is an incredible decline; and I think had the Congress focused on that and been in a position to do exactly the sort of thing you are doing this morning, it might not have happened.

Senator **Bradley**. Thank you very much, Senator Sarbanes. I am very glad you are where you are at this time.

Senator **Sarbanes**. Thank you, Mr. Chairman.

Senator **Bradley**. Our next witnesses are a panel that consists of Dr. Norman Bailey, Consultant Economist of Norman A. Bailey, Incorporated; Mr. Henry Breck, Investment Banker and former partner of Lehman Brothers; and Dr. Richard Weinert, President of Leslie, Weinert and Company in New York. Gentlemen, welcome to the subcommittee today.

I look forward to your testimony. What I would like you to do is limit your testimony to maybe 10 minutes, and then we can go to questions. If you are really on a roll and you are a minute or two over, don't worry; but try not to make a senatorial speech of 25 or 30 minutes. Dr. Bailey, you may be first.

[The prepared written statement of Senator Sarbanes and the New York Times article follow:]

TESTIMONY OF SENATOR PAUL S. SARBANES

TO

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON INTERNATIONAL DEBT

Mr. Chairman:

I appreciate this opportunity to appear before your Subcommittee to discuss the issue of Third World Debt. It is appropriate that the Finance Committee should have a major interest in this issue, since the way in which the debt crisis is managed has major implications for U.S. economic growth and U.S. international trade, major issues the Finance Committee must address.

The nature of my remarks can be summarized briefly in four major points. First, the world economy is seriously distorted by problems associated with Third World debt. Current strategies for managing the debt problem have resulted in severe import compression in the developing countries, with an attendant slowing in export and GNP growth in the industrialized world.

Second, the debt overhang is draining financial resources from the developing world, cutting back on growth and creating serious economic and social problems in a region of the world which is of vital economic and strategic importance to the U.S.

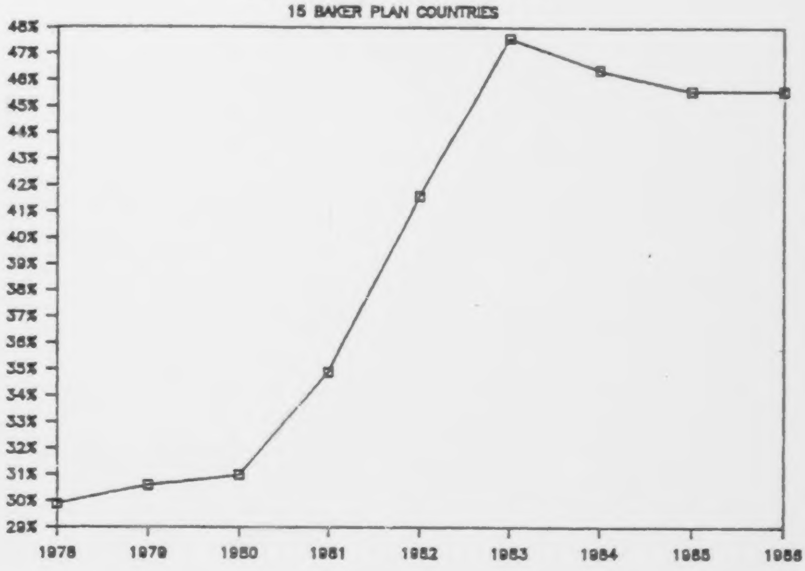
Third, existing approaches to managing the world debt problem have proven inadequate to the task. Although a major financial crisis associated with the debt problem has not occurred, crisis-avoidance is hardly a sufficient indicator of future success. Better ways must be developed to combine management of the old debt with an expansion of growth and trade in the developing world.

Finally, better management of the debt crisis will require us to confront the reality that mistakes were made in the past. Those mistakes must be acknowledged by banks and governments alike. Losses will have to be accepted in a balanced and equitable manner, if we are to move forward to an effective resolution of the problem.

A BRIEF REVIEW OF THE DEBT PROBLEM

I have provided some charts which illustrate the evolution of the debt problem and the challenges it poses for international economic policy:

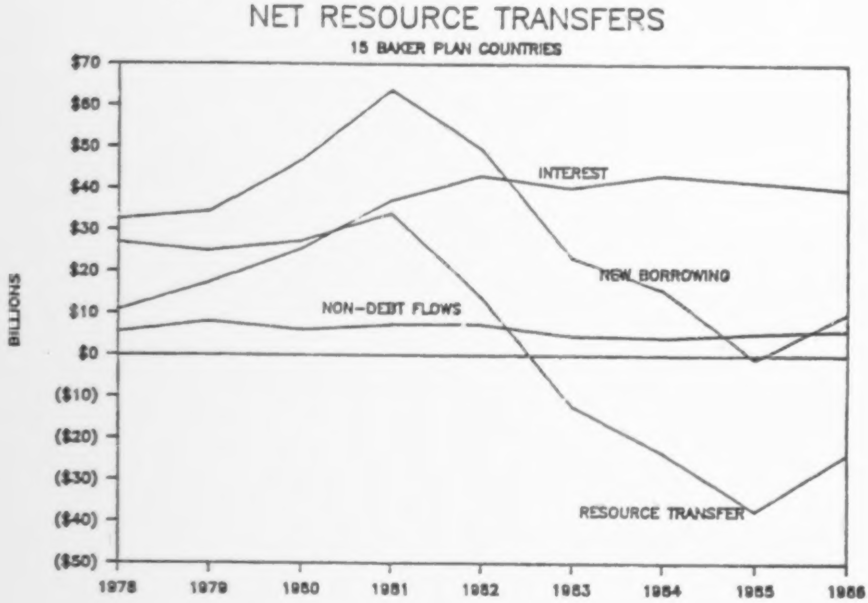
THE PAST FEW YEARS HAVE SEEN LITTLE IMPROVEMENT IN THE DEBT BURDEN



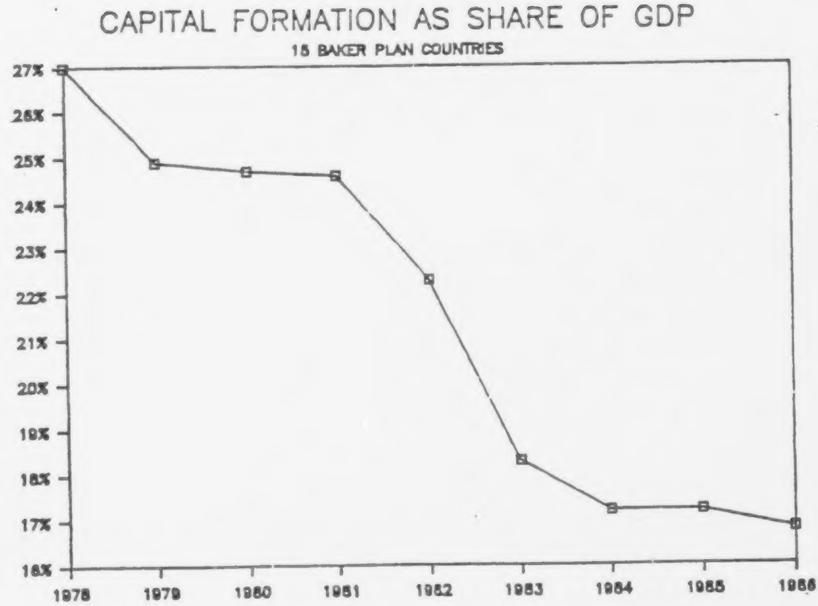
DEBT TO GDP RATIO

15 BAKER PLAN COUNTRIES

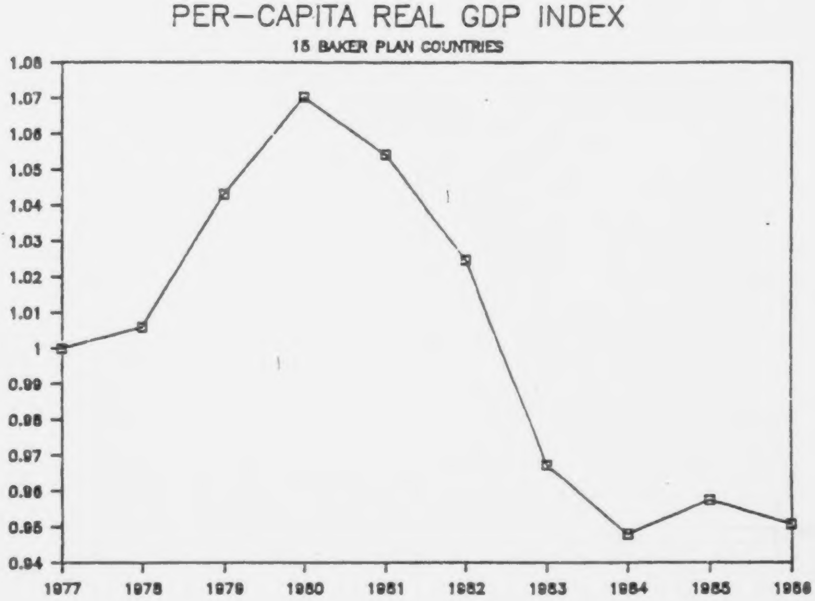
THE CESSATION OF VOLUNTARY BANK LENDING HAS SHIFTED THE RESOURCE TRANSFER EQUATION SHARPLY TO THE DISADVANTAGE OF THE DEBTORS



EXPORTING RESOURCES HAS LED TO A SHARP DECLINE IN INVESTMENT IN THE DEBTOR COUNTRIES



FALLING INVESTMENT HAS HELPED DEPRESS GROWTH IN THE DEBTOR COUNTRIES

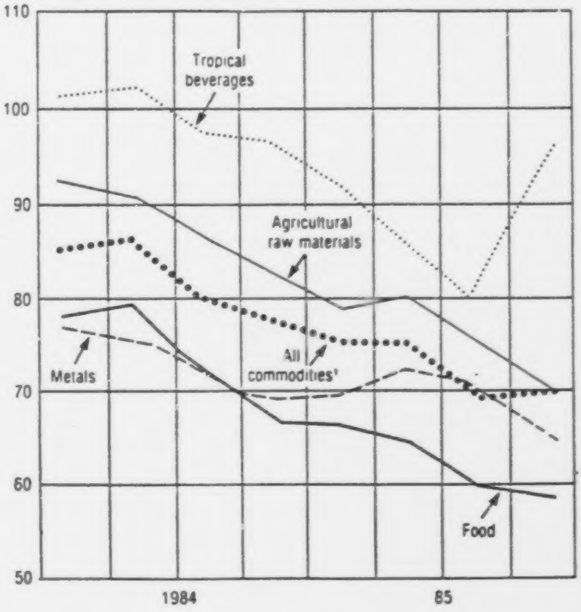


DEBT IS A PROBLEM FOR THE WORLD ECONOMY AS WELL.

EXPORT-PROMOTION PROGRAMS HELP DRIVE DOWN COMMODITY PRICES

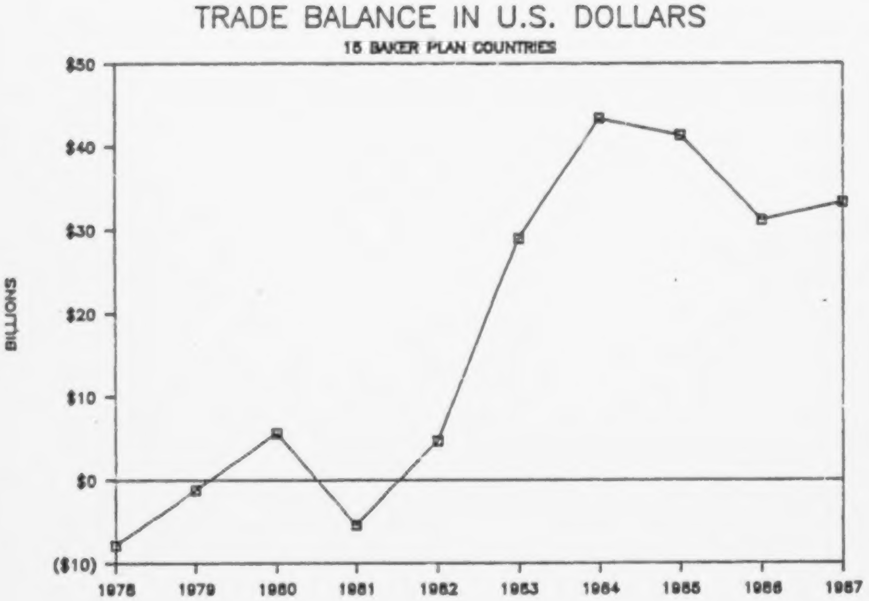
Primary Commodity Prices

(1980 = 100, in US dollars)

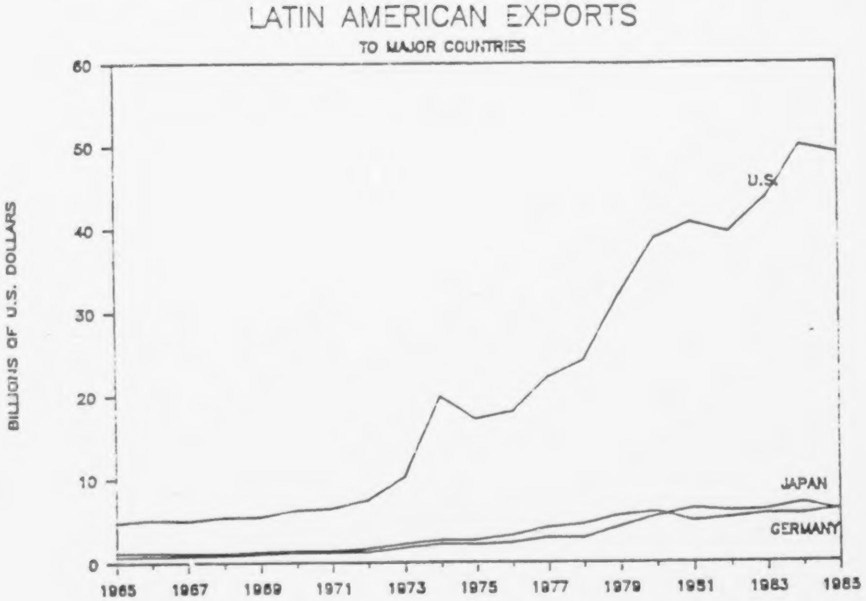


¹Index comprises spot prices of 30 primary commodities.

DEBT-SERVICING PRESSURES HAVE REQUIRED A DRAMATIC SHIFT FROM DEFICIT TO SURPLUS IN TRADING ACCOUNTS OF DEBTOR NATIONS



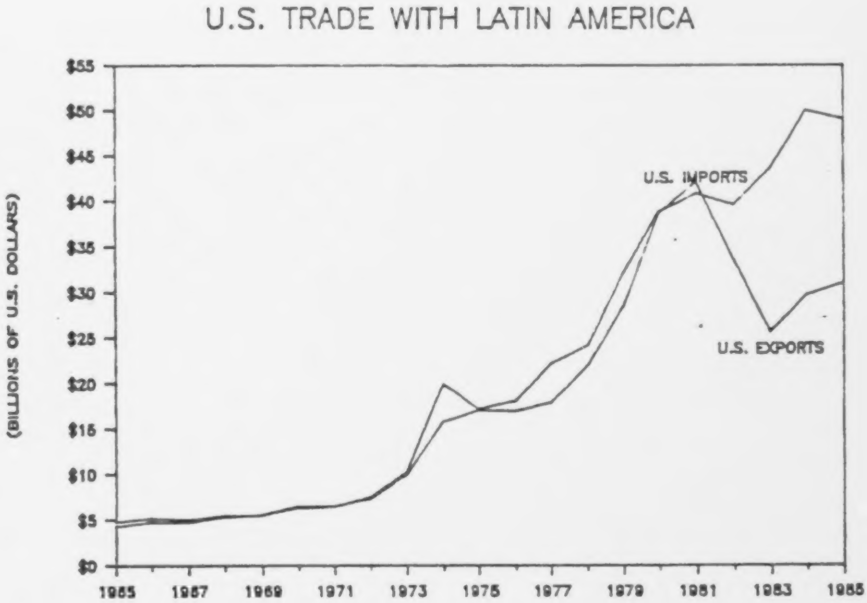
THE U.S. MARKET HAS PROVIDED MOST OF THE NEW EXPORT REVENUES NEEDED TO PAY DEBT SERVICE



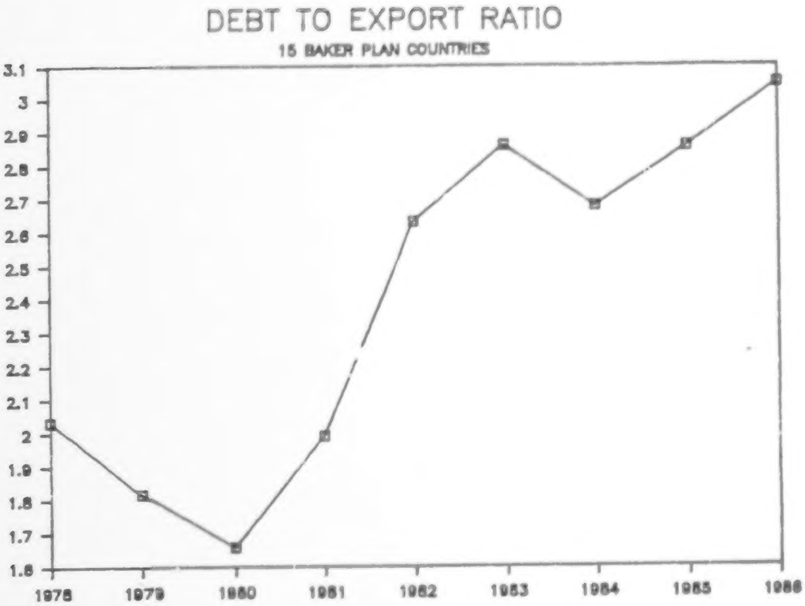
LATIN AMERICAN EXPORTS

TO MAJOR COUNTRIES

U.S. TRADE WITH THE DEBTOR COUNTRIES HAS DETERIORATED DURING THE DEBT CRISIS



KEY DEBT SERVICE RATIOS IN DEBTOR COUNTRIES ARE WORSENING



These charts portray a problem which has not markedly improved, despite five years of concerted effort by the major industrialized countries to manage it. The initial strategy of coping with a collapse in external lending through IMF mandated austerity failed to achieve success, and has been replaced with a new strategy, the Baker Plan, designed to speed up growth in the debtor countries by providing substantial new public and private lending.

The emphasis on growth in the Baker Plan is a welcome new development, but there is substantial concern about whether the mechanisms which are part of the Baker Plan are adequate to the task of re-starting growth in the developing world.

The first problem is one of scale: the sums mentioned by Secretary Baker are far too small to provide the external finance needed to re-start the growth process in the debtor countries. At present, the 15 countries mentioned in the Baker Plan are paying approximately $40 billion per year in interest payments on their old debt, and receiving less than $10 billion in new capital flows from official donors and private investors. This means a net outflow of financial resources of some $30 billion per year. The Baker Plan would reduce the yearly outflow by only $9 billion, leaving the poor countries as substantial exporters of capital at a time when more domestic investment is needed for growth.

The second problem is one of concept: The plan provides new resource flows through additional lending, at a time when debtor countries are already burdened with an unsustainable amount of debt. As the following chart suggests, key debt service ratios for the 15 "Baker Plan" countries have deteriorated over the past several years, rather than improved. This raises some questions about the willingness of both banks and debtors to add more debt to an already excessive external debt burden.

The third problem is one of practicality: It is proving extraordinarily difficult to persuade the commercial banks to come up with the money to fund new involuntary lending packages. It has taken more than a year simply to negotiate a loan agreement with Mexico, and disagreements among the banks continue to block final agreement on the package. Many commercial banks have indicated their objections to more "forced" lending, and it would seem likely that this resistance will only increase in the future.

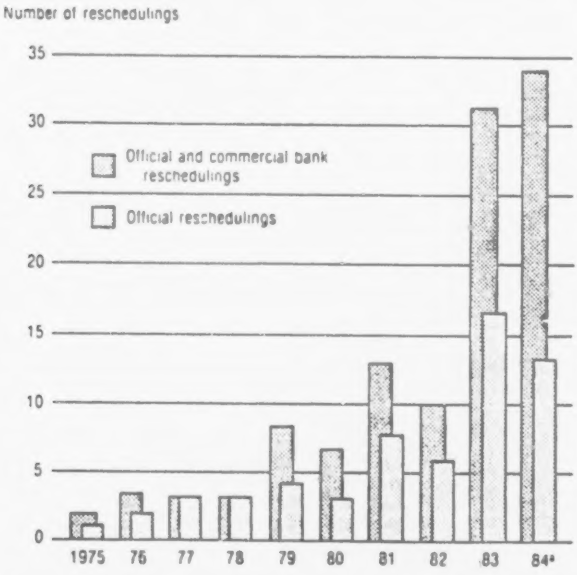
THE NEED FOR A NEW APPROACH TO THE DEBT PROBLEM

It is possible that the world economy could continue for a while with the current set of policies to manage the debt crisis. But prudence suggests a need to develop new solutions to the debt problem, solutions which help reduce the debt burden on the developing world, rather than increase it.

Such a new approach would require coming to grips with the problem of the old debt.

OLD DEBT CANNOT BE REPAID AND MUST BE RESCHEDULED

Multilateral Debt Reschedulings (1975–84)



* Data include commercial bank reschedulings agreed to in principle but not signed as of the end of 1984.

SOURCE: World Bank data

Adding new debt to the balance sheet of a troubled borrower is rarely the route of choice for banks in dealing with the domestic corporations. The preferred method is generally to restructure the company and accept some losses on the old debt, so that the enterprise can get back on its feet as a going concern in the future.

To apply this analogy to the international scene would require banks to recognize that mistakes were made in the past, and that some of the existing debt is excessive and beyond the capacity of the borrower to repay. Recognizing these losses would help clear the way for a swift recovery in the debtor countries, and set the stage for more responsible debt financing in the future.

In recent months, it has become apparent that a significant number of banks are willing to contemplate precisely this type of loss recognition. Loans to debtor countries are being actively traded in the secondary market, at deep discounts from their face value. Each sale at a discount represents a recognition of losses on past debt, and the rising volume of secondary market sales clearly suggests a growing bank willingness to accept these past losses.

What is missing is an effective mechanism for translating the losses experienced by the banks on discounted loan sales into equivalent gains for the debtor countries. A loan sold at a discount to a speculator, for example, produces a higher rate of return for the speculator but leaves the debtor country saddled with the same debt burden as before.

Some contemporary mechanisms, such as the debt-for-equity swap, make use of the secondary market to extinguish old debt and replace it with equity. This may, under some circumstances, produce a financial advantage for the debtor country, but this is by no means guaranteed by the simple act of converting debt to equity. In any case, the market for debt/equity swaps is far too small to come to grips with the full size of the debt overhang.

THE NEED FOR AN INTERMEDIARY

Existing secondary market activities could be substantially enhanced by the creation of an intermediary which would manage the process of converting bank loss recognition (through discounted loan sales) into improved debt service positions for the borrowing countries. The House Banking Committee has already marked up legislation which moves in this direction, by calling for the creation of an international debt management facility.

Such an intermediary would make a greater range of options available to banks for responding to the debt crisis. It would certainly not preclude any new bank lending in situations where additional debt seemed justified by commercial considerations. In situations where additional lending was not prudent, however, the existence of an intermediary would create a way of providing equivalent resource transfers to the debtor countries through loss recognition on old debt. By offering the opportunity for voluntary loss recognition to banks and countries, an intermediary would improve the flexibility and capacity of the international financial system to manage concurrently both the debt and the growth problem.

U.S. INTERESTS IN THE DEBT CRISIS

The creation of some intermediary institution would help to further important U.S. interests at stake in the debt crisis. Specifically, the U.S. has four key interests which could be furthered by such an intermediary.

1. Foreign Policy Interests: The U.S. should be strongly supportive of trends toward democratization in the Third world. Sustaining new democracies requires economic growth and stability, both of which could be furthered by a debt-reducing growth strategy, managed through such an intermediary.

2. Safety and Soundness of American Financial institutions. American banks have largely avoided loss recognition on loan assets which are heavily discounted by private financial markets. As a result, American banks appear to be sounder than they really are and are less prepared for the possibility of future loss or default on these loans. The safety and soundness of the banking system, and the accuracy of bank financial disclosure, would be enhanced by improved mechanisms for loss recognition by banks on their existing third world debt.

3. U.S. trade. Estimates vary about the size of the negative impact on U.S. trade which debt-induced austerity has produced. There is however no doubt that imports have been severely depressed in most debtor countries for the past several years. Significant pent-up demand could be released in countries where the debt servicing problem is resolved.

4. Global economic stability. The U.S. remains the world's largest economic power and bears the leader's usual burden of having to be concerned about the well-being of the international system as a whole. Producing an orderly adjustment by the world economy to a declining American trade deficit is going to require substantial market growth elsewhere in the world economy. At the same time, mechanisms must be found to encourage the reduction of trade surpluses in certain chronic-surplus countries. Both goals require a better process of channeling financial resources from surplus to debtor countries than is currently in prospect. The kind of financial intermediary currently under discussion could provide an effective institutional mechanism for the productive recycling of capital from surplus to debtor countries.

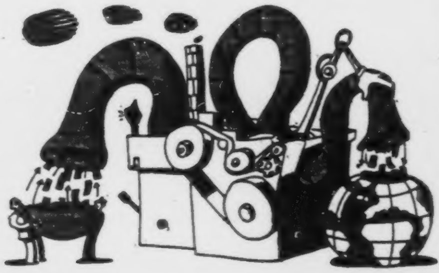
THE NEW YORK TIMES, SUNDAY, NOVEMBER 9, 1986

Forum

A MARSHALL PLAN FOR THE 80's?

'Recycling' Surpluses to the Third World

By DAVID R. OBEY
and PAUL S. SARBANES



THE world economy is in serious trouble, wracked by major tensions that threaten to derail what the World Bank already calls "hesitant recovery." Tuesday's election demonstrates that the precarious health of this recovery is also uppermost in the minds of millions of Americans, whether they earn their livings in older, smokestack industries, new high-tech companies or family farms.

At the heart of this concern is the tremendous increase in the United States trade deficit. The soaring American trade deficit has provided almost all of the growth in world import demand in the last few years, but now stands at a level that simply cannot be sustained. At the same time, the rising surpluses of West Germany and Japan call forth ever stronger demands for protective action.

Addressing the trade deficit and putting our economy back on a sound basis, therefore, must be a top priority when the 100th Congress convenes in January. Central to this effort is restoring growth in world demand for our exports. This, in turn, can best be accomplished by addressing the problems of third world debt, which continues to depress United States markets and destroy United States jobs.

Reducing the extraordinary trade imbalances in the world economy without provoking a global recession requires rapid market growth outside the United States. This reality explains the increasing demands by the United States for faster growth an lower interest rates in Japan and West Germany.

But these proposals, while positive, are simply not up to the task of substantially reducing today's extraordinary imbalances. According to a recent study by the International Monetary Fund, increased growth in both of these countries is likely to reduce the United States trade deficit by only between $5 billion and $10 billion, a drop of less than 10 percent.

To get the machinery and resources for maximum economic growth, developing nations need to import more than they export, but faster growth in imports than in exports must be financed by capital flows from abroad. During the 1970's, when banks were willing to lend, imports in the developing world grew 60 percent faster than exports. But the onset of the debt crisis caused net private lending to "problem" countries to drop from $38 billion in 1981 to a negative $1 billion in 1986. Without finance, these countries were forced to cut imports by more than 30 percent between 1981 and 1986.

There is a growing recognition that providing more finance is essential for restoring growth in income and imports in the developing world. Treasury Secretary James A. Baker 3d, for example, has called for some $10 billion a year in new lending to heavily indebted nations, while the World Bank and others have estimated that as much as $21 billion a year will be needed.

These proposals, while steps in the right direction, are ultimately inadequate, because merely adding new debt to the old will solve nothing. The Baker plan countries must dedicate more than 47 percent of their export earnings to servicing existing debt, compared with only 17 percent for other developing countries. Banks are understandably reluctant to lend more money to countries that already lack sufficient export earnings to service existing debt, finance domestic investment and fund an adequate level of imports.

INSTEAD of simply lending more, we need to give greater attention to reducing the outflows associated with the existing debt. To accomplish this, we should establish a new "special facility" at the I.M.F. or the World Bank to buy, and then restructure, outstanding debt from the banks.

Restructuring would improve creditworthiness in three ways. First, the facility would purchase loans at a discount from their face value, and then pass the discount along to the developing nations. Banks would have to recognize losses on these loan sales, but in return would get increased liquidity for new lending and relief from the expense, complexity and dangers of future debt renegotiations. Second, the facility would transform the short-maturity bank loans to the longer-term lending needed for development. This would have the crucial benefit of cutting the annual debt service burden considerably. Third, the facility would charge lower rates on loans, because it would not be trying to earn profits and it would obtain funds at the lowest market rates.

To have a major impact, the facility would need to be large enough to buy significant amounts of outstanding debt each year. The financing for such a facility would have to come largely from countries that have strong current account surpluses. They would be asked to "recycle" their capital to promote world growth in the fashion pioneered by the Marshall Plan.

There is another precedent as well. In the 1970's, the I.M.F. established a special "oil facility" to compensate for the huge current account surpluses that were run up by the members of the Organization of Petroleum Exporting Countries. Today, Japan and West Germany have current account surpluses nearly four times larger than the OPEC surplus that gave rise to the oil facility. Thus, it is well within their means to finance the proposed debt facility.

Capital recycling will take place even in the absence of a special debt facility. But uncoordinated and bilateral actions could easily increase trade imbalances by tying new finance to the purchase of imports from the surplus countries. A multilateral facility would recycle funds more evenhandedly, reducing rather than expanding world trade imbalances.

Creation of such a facility would not be a total solution to the world's trade imbalances, nor would it be an alternative to domestic demand expansion in the surplus countries. Freed of some of its debt burden, the third world could play a major role in the growth of world demand, but such growth cannot be expected to take the place of more robust demand growth in West Germany and Japan.

Is a special debt facility politically feasible? We think so, because the resumption of third world growth is in everyone's long-term self-interest. Five years of "muddling through" on the debt crisis have only increased the weight of the debt burden, and have continued to stifle import growth in the developing world.

Failure to relieve the financial constraint on third world countries could lead to falling incomes in the developed world, rising protectionism and a fall in world trade reminiscent of the 1930's. To avert this, the United States and the surplus countries must shelve their other differences and support a debt facility that could restart the growth engine in the developing world. ■

Representative David R. Obey, Democrat of Wisconsin, is chairman of the Joint Economic Committee. Senator Paul S. Sarbanes, Democrat of Maryland, will be the chairman of the committee in the next Congress.

STATEMENT OF DR. NORMAN A. BAILEY, CONSULTANT ECONOMIST, NORMAN A. BAILEY, INC., WASHINGTON, DC

Dr. BAILEY. Thank you very much, Mr. Chairman. Before beginning my formal testimony, I might say that in its extremely interesting and imaginative approach to the international or the LDC debt crisis, the Japanese banks have resolved the three problems that Senator Sarbanes mentioned with reference to the Sarbanes-Obey plan which is, as you know, very similar to the LaFalce plan, and that should be studied very carefully by all people who are concerned with this issue.

The way the international debt crisis has been managed since its inception in Eastern Europe in 1981 has rested on the following assumptions, none of which has proven correct. In the first place, most of the debtor countries suffered from a temporary shortage of hard currency liquidity, which could be cured by lending them additional funds to tide them over while they improved their cash flow surplus, by depressing domestic demand, and/or exporting more. That was not true.

Second, this process would be facilitated due to developments in the creditor countries, including steady real growth of three percent per annum or more, leading to greater demands for the goods of the debtors and an improvement in their terms of trade, as well as declining market interest rates—all of which would facilitate, three, a return to the credit markets on a voluntary basis, generally forecast for 1985-1986. With the single exception of a decline in nominal interest rates, none of the foregoing has taken place.

The diagnosis, prescription, and prognosis were all wrong. The premises were unrealistic, and there has been no return to the credit markets. Every debtor country has its own story. As with creditor countries, the debtors have performed both well and badly from the various perspectives that can be taken; and I might point out or underline what Senator Sarbanes said. After all, the United States—at least with reference to these countries—is still a creditor country and has performed extremely badly.

For example, Colombia, one of the few debtor countries not structurally overindebted, was pushed into a completely unnecessary liquidity crisis by the banks themselves, who suddenly discovered that the country is in South America and cut off its credit lines. When we are told by the Polyannas of the debt crisis that a particular debtor country is "out of the woods," because it is a "model for the debtors in general," this is an excellent leading indicator that in six to 12 months that country will have a payments crisis.

There has been no return to the credit markets. Net flows remain negative, and even the international financial institutions are presently taking more funds out of these countries than they are putting in, the Baker Plan notwithstanding. One of these "model debtors" has been Senegal. This West African country, flagellated by drought, has applied all the medicine prescribed for it by the IMF and creditor governments. The result? It is requesting $600 million a year until 1992 and, even if it gets it, to quote the Financial Times of March 31, 1987, ". . . officials privately doubt whether there is any realistic prospect of meeting external debt obligations without indefinite rescheduling."

In other words, debt piling on existing debt will go on compounding forever. At the opposite extreme, one of the largest debtors, Mexico, was also once considered a model. It is now in the process of increasing its huge external debt by one-eighth, and this exercise in financial insanity is hailed as a great triumph.

In a recent study, it was demonstrated that the investment gap created since 1982 by the application of a superficial and counterproductive program is larger than the debt itself and "the accumulated damage is such that we cannot reach a GDP from which the required investment can be carried out."

In other words, unless the debt burden is reduced, much less continually increased, Mexico will never be able once again to register a rate of real growth sufficient to make up for the lost years. Does anyone seriously believe that the people of Senegal or Mexico will put up with this forever?

I would like to mention at length the example of a medium-sized debtor, a typical country between the Senegals on the one hand, and the Mexicos, on the other hand.

This country is Ecuador, a prime example of how virtue goes unrewarded and unrequited under the existing system. Ecuador's total external debt is about $8 billion, of which about $5.5 billion is owed to commercial banks. A strong economic liberalization program was started in Ecuador in 1984, when the new democratically elected government took office. It involved the following points.

Multiple and overvalued exchange rates were substituted for unified realistic rates. A freely floating exchange rate for all private sector transactions was implemented. Subsidized lines of credit from the Central Bank have been gradually eliminated or reduced. From an implicit subsidy of about 40 billion sucres per year in 1984, Central Bank Credit to the economy had an implicit subsidy of less than 10 billion sucres in 1986.

Most financial transaltions were allowed to be set at freely determined interest rates. Average tariffs have been reduced. Price controls and subsidies were eliminated or lowered significantly.

From negative 3.5 percent GDP growth in 1983, positive rates of 4.0 percent were obtained in 1984 and 1985. All international obligations were met. Inflation was also lowered. From an average of 31.2 percent in 1984, the rate went down to 28 percent in 1985 and 23 percent in 1986.

Multiyear rescheduling agreements were signed with private creditors as well as with the Paris Club. In fact, Ecuador was the first country in the world which achieved a pluriannual rescheduling with its Paris Club creditors. The external sector responded quite well to exchange rate policy, as shown below. And there is a table indicating the exports of the private sector which are everything except oil and which the private sector can then keep the proceeds and use for imports.

Concerning the most recent period, a World Bank study concludes:

> With the adverse oil price shock for Ecuador in early 1986, additional adjustment measures were required. Both exports and fiscal revenues were negative affected. After achieving a small public sector surplus in 1985, suddenly in January 1986 the Government was faced with a deficitary situation. The potential deficit, in the ab-

sence of additional fiscal measures, was estimate to reach about eight percent of GDP. Fiscal adjustments, however, were made.

They involved additional tax increases, the elimination of fiscal subsidies for exports, and the reduction of some public sector expenditure items such as and especially investment, which was cut by 30 percent in nominal terms.

I would like to point out that all of these are highly unpopular measures in political terms and led to the impeachment of the Minister of Finance.

The 1986 public sector deficit is now estimated at about five percent of GDP, less than that which would have occurred without additional fiscal contraction but above that targetted earlier by the Government.

Additional economic adjustment in 1986 involved the promotion of expenditure switching through a continued and accelerated exchange rate adjustment. Following a real depreciation in 1985, the real exchange rate, against the dollar, by November of 1986, had experienced a 21 percent depreciation in comparison with the end of 1985.

As a result, both agricultural output and non-oil exports experienced substantial growth during 1986. This growth and recovery has offset the contraction brought about by the oil shock and the fiscal contraction implied by that shock. Instead of falling, GDP is estimated to have grown by about one percent in 1986. On the whole, the economic policies and development strategy being pursued by the Government are consistent with and conducive to the structural adjustment of the economy and economic recovery."

Despite all this, it was obvious by December 1986 that Ecuador was going to run out of funds to continue to keep current on its debt servicing. It informed its creditor banks of this and requested urgent negotation, asking no new funds but only that the spread over LIBOR be reduced and that interest be paid yearly instead of quarterly or semiannually. In response, the bank steering committee delayed six weeks and then said no. At the end of January, Ecuador suspended debt payments. In March, a devastating earthquake demolished the oil pipeline and President Febres Cordero extended the moratorium to one year. Venezuela is lending Ecuador oil to fulfill its commitments, but this will have to be paid back and interest is compounding. Does anyone seriously believe that Ecuador, flagellated by nature and unrewarded for virtue, will ever be able or willing to resume full service of its debt?

There is no time for further delay. There is no time for complex solutions or negotiations. There is no time for long legislative processes. Above all, there is no more time to continue to humor those who have been wrong for five long years and who still refuse to recognize reality. The medium and long-term commercial bank debt must be converted now into long-term bonds at a fixed rate of interest that these countries can pay.

Only in this way can a large, efficient secondary market develop and only in this way can a frozen equation for disaster be rendered relatively harmless.

Thank you, Mr. Chairman.

Senator **Bradley**. Thank you very much, Dr. Bailey. Let's move to Mr. Breck.

[The prepared written statement of Dr. Bailey follows:]

Norman A. Bailey

Consulting Economist

Mr. Chairman, Members of the Subcommitte:

The way the international debt crisis has been managed since its inception in Eastern Europe in 1981 has rested on the following assumptions, none of which has proven correct:

- Most of the debtor countries suffered from a temporary shortage of hard currency liquidity, which could be cured by lending them additional funds to tide them over while they improved their cash flow surplus by depressing domestic demand and/or exporting more.
- This process would be facilitated due to developments in the creditor countries, including steady real growth of 3 percent p.a. or more, leading to greater demand for the goods of the debtors and an improvement in their terms of trade as well as declining market interest rates, all of which would facilitate:
- A return to the credit markets on a voluntary basis, generally forecast for 1985/86.

With the single exception of a decline in nominal interest rates none of the foregoing has taken place. The diagnosis, prescription and prognosis were all wrong, the premises were unrealistic and there has been no return to the credit markets.

Every debtor country has its own story -- as with creditor countries the debtors have performed both well and badly from the various perspectives that can be taken. For example Colombia, one of the few debtor countries not structurally overindebted was pushed into a completely unnecessary liquidity crisis by the banks themselves, who suddenly discovered that the country is in South America and cut off its credit lines. When we are told by the pollyannas of the debt crisis that a particular debtor country is "out of the woods" because it is a "model for the debtors in general" this is an excellent leading indicator that in six to twelve months that country will have a payments crisis. There has been no return to the credit markets, net flows remain negative and even the international financial institutions are presently taking more funds out of these countries than they are putting in.

One of these "model debtors" has been Senegal. This West African country, flagellated by drought, has applied all the medicine prescribed for it by the IMF and creditor governments. The result? It is requesting $600 million/year until 1992, and even if it gets it, to quote the Financial Times (March 31, 1987) "...officials privately doubt whether there is any realistic prospect of meeting external debt obligations without indefinite rescheduling." In other words, debt piled on existing debt will go on compounding forever.

At the opposite extreme, one of the largest debtors, Mexico, was also once considered a model. It is now in the process of increasing its huge external debt by one-eighth and this exercise in financial insanity is hailed as a great triumph. In a recent study it was demonstrated that the investment gap created since 1982 by the application of a superficial and counterproductive program is larger than the debt itself and that "the accumulated damage is such that we cannot reach a GDP from which the required investment can be carried out." In other words, unless the debt burden is reduced, much less continually increased, Mexico will never be able once again to register a rate of real growth sufficient to make up for the lost years.

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- Multiple and overvalued exchange rates were substituted for unified realistic rates.
- A freely floating exchange rate for all private sector transactions was implemented.
- Subsidized lines of credit from the Central Bank have been gradually eliminated or reduced. From an implicit subsidy of about 40 billion sucres per year in 1984, Central Bank Credit to the economy had an implicit subsidy of less than 10 billion sucres in 1986.
- Most financial transactions were allowed to be set at freely determined interest rates.
- Average tariffs have been reduced.
- Price controls and subsidies were eliminated or lowered significantly.

From negative 3.5 percent GDP growth in 1983, positive rates of 4.0 percent were obtained in 1984 and 1985. All international obligations were met. Inflation was also lowered. From an average of 31.2 percent in 1984, the rate went down to 28.0 percent in 1985 and 23.0 percent in 1986. Multiyear rescheduling agreements were signed with private creditors as well as with the Paris Club. In fact, Ecuador was the first country in the world which achieved a plurianual rescheduling with its Paris Club creditors.

The external sector responded quite well to exchange rate policy, as shown below.

MILLIONS OF U.S. DOLLARS

PRIVATE SECTOR EXPORTS		PRIVATE SECTOR IMPORTS	SURPLUS (DEFICIT)
1981	871.6	1812.3	(994.7)
1982	818.7	1863.9	(1045.2)
1983	614.8	1233.4	(618.6)
1984	786.6	856.1	(69.5)
1985	978.3	945.5	32.8
1986	1203.4	975.9	227.5

Concerning the most recent period, a World Bank study concludes:

"With the adverse oil price shock for Ecuador in early 1986, additional adjustment measures were required. Both exports and fiscal revenues were negatively affected. After achieving a small public sector surplus in 1985, suddenly in January 1986 the Government was faced with a deficitary situation. The potential deficit in the absence of additional fiscal measures, was estimated to reach about 8 percent of GDP. Fiscal adjustments, however, were made. They involved additional tax increases, the elimination of fiscal subsidies for exports, and the reduction of some public sector expenditure items, such as and especially investment, which was cut by 30 percent in nominal terms. The 1986 public sector deficit is now estimated at about 5 percent of GDP, less than that which would have occurred without additional fiscal contraction but above that targeted earlier by the Government.

Additional economic adjustment in 1986 involved the promotion of expenditure switching through a continued, and accelerated, exchange rate adjustment. Following a real depreciation in 1985, the real exchange rate, against the dollar, by November 1986, had experienced a 21 percent depreciation in comparison with the end of 1985. As a result, both agricultural output and non-oil exports experienced substantial growth during 1986. This growth and recovery has offset the contraction brought about by the oil shock and the fiscal contraction implied by that shock. Instead of falling, GDP is estimated to have grown by about 1 percent in 1986. On the whole, the economic policies and development strategy being pursued by the Government are consistent with and conducive to the structural adjustment of the economy and economic recovery."

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There is no time for further delay. There is no time for complex solutions or negotiations. There is no time for long legislative processes. Above all there is no more time to continue to humour those who have been wrong for five long years and who still refuse to recognize reality. The medium- and long-term commercial bank debt must be converted now into long-term bonds at a fixed rate of interest these countries can pay. Only in this way can a large, efficient secondary market develop and only in this way can a frozen equation for disaster be rendered relatively harmless.

Thank you, Mr. Chairman.

Table 11: ECUADOR

External Debt By Creditor, 1984 to 1985
(Million U.S. Dollars)

	Beginning of Year		Disbursements		Amortizations		Interest		Adjustments[1]		End of Year	
	1984	1985	1984	1985	1984	1985	1984	1985	1984	1985	1984	1985
TOTAL	6,690.2	6,949.2	1,610.0	1,753.0	1,308.7	1,333.5	834.7	761.5	-42.3	71.0	6,949.2	7,439.7
World Bank	201.0	247.3	66.7	40.6	20.4	28.1	19.3	21.3	--	--	247.3	259.8
Inter-American Dev. Bank	455.3	504.2	73.1	128.7	18.4	32.1	29.0	28.4	-5.8	4.9	504.2	605.7
Other Inter. Organizations	52.6	53.5	3.9	9.5	3.0	10.2	2.5	2.2	--	--	53.5	52.8
Governments	590.6	744.9	235.4	261.2	68.3	124.4	26.1	58.6	-12.8	32.4	744.9	914.1
Banks	4,895.7	4,902.3	1,138.2	1,231.4[2]	1,117.6	1,020.6	725.0	602.1	-14.0	14.2	4,902.3	5,127.3
Suppliers	481.0	495.3	92.7	81.6	68.7	116.5	31.8	48.8	-9.7	19.5	495.3	479.9
Bonds	14.0	1.7	--	--	12.3	1.6	1.0	0.1	--	--	1.7	0.1

(1) Foreign Exchange Rate Adjustment

(2) Disbursements other than disbursements used to refinance existing debt total $90 million.

Source: Central Bank of Ecuador

Table 12: ECUADOR

External Debt By Debtor, 1984 to 1985

(Million U.S. Dollars)

	Beginning of Year		Disbursements		Amortizations		Interest		Adjustments[1]		End of Year	
	1984	1985	1984	1985	1984	1985	1984	1985	1984	1985	1984	1985
TOTAL	6,690.2	6,949.2	1,610.0	1,753.0	1,308.7	1,333.5	834.7	761.5	-42.3	71.0	6,949.2	7,439.7
Public Debt	6,020.5	6,772.2	1,549.0	1,731.1	755.1	1,231.5	808.9	740.7	-42.3	71.0	6,772.2	7,342.8
Central Government	2,389.9	2,429.9	394.7	368.0	341.7	462.2	249.2	259.5	-13.0	30.8	2,429.9	2,366.5
Local Government	131.1	125.3	1.6	3.8	7.4	18.5	10.7	11.8	--	-0.2	125.3	110.4
INECEL	441.4	390.5	11.2	23.4	50.9	65.4	27.2	43.2	-11.2	19.0	390.5	367.5
CEPE	87.4	58.3	0.6	20.9	29.7	21.1	11.1	10.2	--	--	58.3	58.1
Financial Sector	2,558.0	3,421.2	1,129.5	1,256.9	251.6	614.4	431.4	388.0	-14.7	18.4	3,421.2	4,082.1
Other	412.7	347.0	11.5	58.1	73.8	49.9	29.3	28.0	-3.4	3.0	347.0	358.2
Private Debt	669.7	177.0	60.9	21.9	553.6	102.0	25.8	20.8	--	--	177.0	96.9

(1) Foreign Exchange Rate Adjustment

Source: Central Bank of Ecuador

STATEMENT OF HENRY BRECK, INVESTMENT BANKER (FORMERLY PARTNER OF LEHMAN BROTHERS), NEW YORK, NY

Mr. **Breck**. Thank you very much, Mr. Chairman. One of the few good things about the debt crisis, I think, is the formation of this subcommittee. The material I received in advance of this hearing, which posed certain questions, was very impressive; and Senator Sarbanes' testimony shows real sophistication and understanding about this problem. The news is getting around that this is serious.

To take some of the questions that you posed in your advance material: Do current Third World debt management practices promote debt crises rather than reform? Absolutely. We all know this. We are staggering from one crisis to another in the Third World, and it is getting worse, not better.

And private capital, which is what can really help the Third World countries, is never going to go into these economies so long as the overhang of debt exists.

On a net basis, foreign exchange has been drained from the Third World because the various lenders, both official and unofficial, have been very skillfully reducing their exposure. Debt crises breed political crises, and we shouldn't be surprised about this.

I would like to cite a recent quotation from the Wall Street Journal because it is very, very good. This isn't a left-wing publication.

> About 80 million of Latin America's inhabitants live in extreme poverty. They may earn just enough to eat. Since the debt crisis broke almost five years ago, their condition has become more hopeless as more and more money goes to pay off foreign debt and less and less of it goes into the domestic economy. During this period, Latin America's per capita income has fallen about 10 percent. Investment has plunged by one-third. Real wages have dropped, and unemployment in many countries has soared about 50 percent.
>
> Meanwhile, 35 percent of export earnings or more than one-third of domestic savings have gone to pay interest.

Another question you asked in the press release was whether the Third World debtors have anything left to lose when creditors threaten to withdraw credit. They don't.

Although in many countries there are private businesses and individuals which are not insolvent and which are functioning more or less normally, and which would suffer inconvenience if an entire country were redlined, "inconvenience" is the right word. Credit is only a convenience. It is a time and money saver. It is not essential; given a little time and a little effort, businesses and countries can self-finance their affairs. Banks want to get their money paid back.

In any case, secured trade financing for cargoes in the harbor will always be available. The alternative for a county is to be caught in a noose of recurring debt crises and political turmoil, with no net new credit provided anyway. The choice seems easy, and that is why unilateral default is on the increase in the Third World. As Dr. Bailey pointed out, what Ecuador did was completely logical. It is a rational strategy for these countries to follow. They have nothing left to lose. They are being drained of cash by the current rescheduling process. There is nothing in it for them.

A lot of criticism has been leveled at the commercial banks; and in my written statement, I said I thought this was unfortunately a waste of time. The banks are just doing what they think best. They are defending their own interests very capably. They know what they want. They may be helping to create a huge and dangerous long-term mess in the Third World, but this isn't their problem, and it basically isn't their fault.

The countries themselves are the primary culprits. The banks are criticized for their accounting practices, but if I were a big shareholder of CitiCorp, I would be delighted with John Reed, both with his accounting and with his intransigence. He has done a lot for me. I wouldn't want him to give my money away. The debt crisis is five years old, and against all odds, CitiCorp has paid large and rising dividends, and the stock price has doubled.

The banks think they know what they are doing. We are not going to get any help from the commercial banks. They think they can ride through this problem just fine the way they are going. So, what are we going to do about this problem, which I think we all concede is extremely serious?

In doing business negotiations and in making deals, it is an axiom that you have to get the parties with money at risk together. And it is the same here. It is the debtor countries themselves which have to stand up. I don't believe we can do it for them. It is true that we can set helpful precedents by forgiving official debt owed to the U.S. Government, and we can and should press in the World Bank, the IMF, and other international lending agencies for debt forgiveness to the very poorest countries.

But the real debt problem we have to worry about is in Latin America, and there the commercial banks hold a large amount of the total debt. Their schedule for reducing or unloading this debt is very slow, even though they know very well that in the end a lot of it won't get repaid. Their negotiating stance will continue to produce crises and political problems throughout Latin America, so long as the Latin Americans don't act for themselves.

That is why I think what the Brazilians have done, what the Ecuadorians have done, and what the Peruvians did a year ago is hugely healthy. It is very, very good. They themselves have to call time out and declare a form of partial bankruptcy.

This has already begun, and I hope we can encourage it. By "we" I mean the elements of the U.S. Government, the elements of the informal U.S. financial subgovernment, that understands what the problem is. It is basically in our long-term interests to have this debt defaulted, to have a partial bankruptcy declared. Deep down, I am not sure the banks wouldn't actually welcome it.

They know they will have to grapple with the problem one day; it is only a matter of time.

Alan Garcia, to my mind, is a legitimate hero. His decision to pay not more than 10 percent of export earnings is logical, but it was very, very brave at the time. He acted in his own interest. And frankly, I think that he deserves our support. There are problems in Peru, but they would be much worse without his decision.

The Brazilian negotiations will end, I believe, in some similar sort of self-created limit on foreign exchange payments. That is healthy. The Philippines have chosen another route which, as I understand it, in effect pays interest in local currency, which is a clever technique that the Chileans through their debt-equity swaps have pioneered. All of this is constructive. It needs encouragement from you as it goes ahead.

My own position is that, rather than pass legislation—which I have a great deal of difficulty drafting in my own mind—I would hope you could become an active cheering section to see how this process moves ahead in Latin America. I think the moment may come when we have to take fairly dramatic action in this country, but I don't quite think we are at that point yet.

But the sentiments that you express and other members of Congress express can be very, very important in this process. I think what you have done is marvelous. Thank you.

Senator **Bradley**. Thank you very much, Mr. Breck. Dr. Weinert?

[The prepared written statement of Mr. Breck and an article from the Wall Street Journal, Nov. 7, 1986, follows:]

TESTIMONY OF HENRY R. BRECK

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL DEBT OF THE

SENATE FINANCE COMMITTEE

April 6, 1987

Thank you for the opportunity to say a few words on the debt crisis. By the way of introduction, I am an independent businessman in New York with some service abroad for the U.S. Government and almost 19 years of investment banking experience. I am also a Trustee of the Natural Resources Defense Council, an environmental group which has taken an interest in the ecological and environmental problems which have developed in the third World, some of which can be directly traced to large and ill-advised borrowings.

It is a particular pleasure to appear before this Subcommittee of the Senate Finance Committee, because for those of us who think this problem is serious, the very existence of this Subcommittee is encouraging. Is not easy to find attractive political angles to the debt crisis, and there are no easy votes to be gained in this messy, complicated, difficult problem. Nevertheless, the debt crisis is real, it is beginning to hurt American citizens directly, and that in it's various aspects it will do considerable damage to our country as time goes on. Therefore public consideration of the problem in a forum like this can be very helpful.

Perhaps the only good development about the debt crisis over the past five years is that the information base about the problem has become very broad and generally accepted by all sides. To use a legal analogy, the "discovery phase" is over and the facts are in the public domain. Five or six years ago it could have been termed a revelation that the countries of the Sub-Sahara were, taken as a whole, insolvent. I recall some highly capable State Department officers calling on a group of investment bankers in New York, bearing the message and urgently asking for advice on how to reduce Africa's debt load. We replied cynically that if one went to call on Walter Wriston at Citicorp he would say that there wasn't a bad loan in all Africa ... and in 1982 Wriston would have said it. Only three or four years ago it would have been regarded as extreme to say that Bolivia, Peru, Ecuador, and Brazil would soon be unwilling to service their debts. Now, the facts are front-page news, and commercial banks will quote market discounts for the Third World loans they have made: 12 for Peru, 58 for Argentina, 60 for Mexico and Brazil.

We have also become very familiar over the past five years with the elaborate and almost ritualized drama which the debtor countries and creditors play out. First, the debtor country announces that it will have trouble servicing its debts. It is then instructed by its creditors to accept IMF discipline, which it does not wish to do. Sometimes the IMF intervenes, sometimes not, but no progress is made towards resolution of the problem and the second stage of the drama is an announcement that the country cannot pay, despite good intentions. This leads to a bank conference which produces a restructuring whereby principal payments are rescheduled, mainly pushed out to later years. Interest payments have to be made so the banks extend new loans to the debtor country to pay the interest. The new loans are added to the country's total of debt, the interest is booked as income, and the money moves at the speed of light from one account in the lending bank to another. No new money is actually going into the debtor country. As a matter of fact cash is actually extracted from this circular flow of funds for fees and other expenses. There is also inevitable leakage from the debtor country to confidential accounts abroad, which were have come to accept as normal. It is accepted in this graceful financial minuet that nobody wants a default. At the end of negotiations, both sides, bankers and debtors alike, head for the bar with a huge cry of triumph, knowing full well that within a year or so they will be back at the negotiating table again for a new restructuring.

Meanwhile, all is not well for the citizens of the debtor country or for its economy. One need not seek out Peace Corp workers or left-wing priests to get a sharp fix on what has happened to Latin America as a whole while these financial negotiations have been going on. In the Wall Street Journal, March 24th, 1987, Roger Cohen said it as well as it ever could be said:

> About 80 million of Latin America's inhabitants live in extreme poverty ...' They may earn just enough to eat. Since the debt crisis broke almost five years ago, their condition has become more hopeless as more and more money goes to pay off foreign debts and less and less of it goes into the domestic economy. During this period Latin America's per capita income has fallen about 10%, investment has plunged by one third, real wages have dropped and unemployment in many countries has soared about 50%. Meanwhile, over 35% of export earnings or more than one third of domestic savings have gone to pay interest on Latin America's foreign debt of $360 billion, a sum equivalent to 60% of its gross national product.

In passing, we should not forget that Latin America, with all its troubles, is incomparably better off than other areas suffering from the debt crisis such as sub-Saharan Africa. The GNP per capita of poverty-stricken Ecuador, in default, is eight times that of Zaire.

The effects of graphically described in the Wall Street Journal are perfectly understandable and predictable. The debt has levied a huge tax on these societies and has greatly reduced equity investment. Few entrepreneurs, whether local or foreign, will invest their money and (just as important) their time and effort in countries where a huge and growing balloon of senior debt exists. It is evident to all potential investors that the debt problem is getting worse, not better, despite austerity measures, IMF plans, deferrals, and restructurings, for huge stress is put on societies which are politically fragile. The time of competent officials is consumed with this problem in many countries where there is no surplus of trained financial specialists. I have a letter from an American Foreign Service officer describing the actual collapse from exhaustion of the Finance Minister of a big debtor country, literally overwhelmed by the work load.

I said at the beginning of this testimony that the debt crisis was beginning to hurt Americans. Ask a Caterpillar Tractor dealer in San Antonio how his sales to Mexico are. Ask the Chief Executives of Eastman Kodak and Westinghouse if they are happy with their level of sales to Latin America. Americans cannot sell products to societies which are bankrupt. I believe farmers and workers in America are now off the farm and out of work to some extent because our exports to Latin America, and to all the Third World, are being reduced by the debt crisis. First, we find it hard to sell to these countries because they have no money. Second, to the degree that they export too, they must compete ferociously for foreign exchange, making our own exports to the world market more difficult.

Another very real danger caused to America is the high level of environmental damage now going on throughout the Third World. Forest destruction is perhaps the most topical aspect, for were have become increasingly sensitive to such potential problems as the increasing level of carbon dioxide and the destruction in the atmosphere. But nothing could be more logical for Third World farmers living on the edge than to cut down some trees so as to be able to plant some food. While this topic deserves much more treatment than can be given in this testimony, it is common sense that environmental protection, so critical to the whole world, can only be achieved in politically disciplined societies with a modest bit of economic surplus. In societies pressed to the wall, pollution control devices and environmental restrictions are unaffordable luxuries. Political chaos also makes environmental protection difficult. Elimination of the rain forests of the Amazon Basin may eventually turn out to be one of the nastiest effects of the Latin American debt problem.

Many of the debts incurred by the countries of Latin America have not only been financial disasters but have badly damaged the environments of the borrowing nations. The Natural Resources Defense Council, if which I am a Trustee, has documented some of these environmental disasters. For example, the World Bank's loan to support the notorious POLONOROESTE resettlement project in Brazil resulted in uncontrolled destruction of vast areas of undisturbed tropical forests, with no long-term development gains.

The evil effects of the current policy of debt restructuring are so evident that commercial banks draw substantial criticism for their hard-nosed attitude toward debt collection, their lack of flexibility, their stinginess about lending new money, and their general lack of compassion, but criticizing the banks is a waste of time. The big U.S. commercial banks are in tough position and are fighting hard for what their managements consider to be the interests of the shareholders and incidentally of management as well. Those who say the banks are too tough have never run into the "work-out team" from Citicorp. Banks are not in the business of giving away money and to attack them for their negotiating stance is like criticizing a weasel for killing chickens. They are doing an excellent job for themselves. The pain and economic suffering they have managed to inflict on Latin America and other areas of the Third World and the truly remarkable sluggishness of Third World political leaders is the evidence. So is the stock price at which these big lenders trade. In August, 1982, when the debt crisis first became public, Citicorp stock was trading around $24 a share. It is now roughly $50 a share and has been as high as $60 7/8, and meanwhile Citicorp has paid out $1.3 billion in dividends over the past five years. Whatever the policies of these banks have done to Latin America, they have done well by their shareholders. Even the most exposed of the big New York banks, Manufacturers Hanover, has stock price up 50% since August, 1982, during which time it has paid steadily increasing common stock dividends.

Critics of the U.S. commercial banks are fond of pointing out that the earnings recorded by these banks are phony, namely, the interest they book when they make new loans, which make a light-speed transfer into the interest account at the same bank, but this is not really the banks' fault. U.S. accounting rules in effect force the banks to do this. The U.S. banks cannot maintain large hidden reserves against losses, as European banks are permitted to do. These earnings are also taxable, something not wholly unattractive to the Treasury. If anything, it is the dividends paid by the banks which should be criticized, for these are permanent cash transfers which escape the banks, when according to some realistic views of the situation they really did not "earn" anything like what they reported and are actually paying so-called dividends out of scarce and endangered capital.

But U.S. bank managements are not stupid. They are acting rationally on full information and have in effect made a huge bet that the U.S. commercial banks can ride out the Latin American banking crisis. To date, they have been 100% right. Every day since August, 1982, their position has become stronger. Every month, more reserves are set away. Every day that the stock price is maintained and every three months when the dividend is paid, stockholders get something back. Remember, if there is real trouble, there will be no dividends. Long-term, these banks have absolutely no intention of increasing their lending to Latin America or any other troubled situation. On the contrary, they are working methodically towards the day when they can package and securitize some of their Latin American loans and unload them on the world market, taking that amount of loss which they feel they can bear. This workout process is the only way the banks can deal with their exposure, for they clearly cannot seize farms and drilling rigs as they have in Texas. They have a long view and they are doing from their standpoint a very workmanlike job.

What happens to the debts countries during this "rescheduling" or "work-out" period is not the banks' problem.

It is, however, our problem, very much so, for all reasons discussed earlier in this paper. Economic damage to the Third World will hurt us economically, politically, environmentally, and perhaps even militarily. In my opinion, this banking problem is simply too important to be left to the bankers. The effects of it will ripple out to hurt us all. The cost of their workout policies is expensive.

The Reagan Administration, at least the Treasury Department, seems concerned about the impasse between the banks and their Third World debtors, but it has an extremely difficult tight-rope to walk. The first responsibility felt by any central banker is towards the soundness and solidity of the nation's financial system, which makes it difficult for the Administration to take initiatives to soften the stance of creditors, both official and unofficial. Just as the banks must defend their interests, so the Treasury must play its assigned role. I think the Administration has not received sufficient credit for the Baker Plan, which showed a penetrating understanding both of the problems of the Third World and of the intransigence of the commercial banks. The basic idea of the Baker Plan was to provide "new money" -- really new money, not some circulating account -- to those countries which followed sensible economic policies. This was well-timed and intelligent, because in most of the Third World countries foolish and misguided economic policies have been the root cause of their difficulties. If capital has fled from the Third World, it has been for good reasons. Also, the Baker Plan coincided with an obvious intellectual trend against Marxist ideas, state-run industries, and punitive taxation. However, the Baker Plan is a bit undergunned for the size of the problem, and , as noted above, the idea that commercial banks will voluntarily increase their net lending to troubled areas such as Latin American is fantasy. They won't do it.

But even is they did, and even with the most enlightened economic practices, and even with Messrs. Baker, Darman, Gould, and Mulford at the helm, it is difficult to believe that growth and development would pick up so long as the colossal overhang of prior debt exists. While the load varies widely from country, and while some countries, such as Argentina, are so endowed that they can probably dig themselves out of almost any mess, for Mexico and Brazil, our neighbors, and for our long-time friends in the Philippines, there simply has to be a substantial reduction in the level of long-term, permanent prior claims on the free cash flow of the society. Free enterprise is hugely effective, but the huge and rising bank debt can stifle it.

So what is to be done? We have an intractable and damaging problem, a sort of financial Love Canal, and in a democracy we must try to get the various parties together to see what action can be taken. It is frighteningly complicated problem: 50 or 60 different countries, different political systems, different lenders, contesting interests on all sides. No wonder most Members of Congress stay away from this issue.

There are technically two aspects to the problem: the official debt owed to the U.S. Government and to multilateral institutions such as the World Bank, the other multilateral banks, and the IMF, and the private debt which is owed to the various commercial banks around the world. It is the U.S. commercial banks with which this Subcommittee is primarily concerned, but, in my opinion, a very significant step forward would be for the U.S. Government to forgive obligations owed to it by the poorest nations of the world, those with a GNP per capita of less than $750 per capita. This would include almost exclusively sub-Saharan countries.

A bill has been introduced in the House on this subject, H.R. 1199 introduced by Congressman Wolpe, which directs mandatory rescheduling of U.S. Government loans to the poorest countries of the sub-Sahara and also directs the Secretary of the Treasury to seek generous restructuring of IMF, World Bank, and other international loans. If it gets to the Senate, I hope you will support it. If not, I hope you will introduce similar legislation. On official debt, I also would urge you to continue to put pressure on the Adminstration to follow a policy of debt stretch-out at the least and forgiveness at the best for the poorest countries, for it is self-evident that forgiveness will cost us nothing. On a net basis these loans will never get paid back.

In the case of official debts owed by the poorest nations to the multilateral banks, it is only fair that those institutions, not the borrowing countries, should bear the costs of these badly designed projects. Often, the multilateral banks have far more access to information about the viability of these projects than the borrowing countries, and the banks usually participate closely in their design. Considering that many of these projects also have caused great environmental harm, for the development banks to insist on repayment of the loans is like a restaurant owner's demanding payment after serving spoiled food.

Debt forgiveness is anathema to bankers and international bureaucrats such as those at the World Bank, but it would set a very helpful precedent. It would indicate U.S. political understanding of the problems faced by these very poor societies and a U.S. governmental realization that the debts cannot in fact ever be paid. Incidentally, we would be following the example of Canada and other European countries in forgiving these loans, in effect converting them to grants.

For Latin America and countries such as the Philippines, where GNP per capita is higher and commercial bank debt is relatively more important, the problem is much more difficult. Various suggestions have been made that U.S. commercial bank debt be written off by U.S. Government direction or that limits be imposed by legislation on the amount of annual payments which could be accepted -- e.g., not more than 20% of a country's export earnings. While the cause is sympathetic, this would amount to an expropriation of private assets, and I doubt that our system should accept this sort of precedent. Legislation to compel private banks to accept lower payments would seem to be an absolute last resort. Of course, had different accounting practices been permitted in this country, so that U.S. commercial banks could build hidden reserves like European banks, this problem would be much smaller in size,[1] but we are stuck with our history, and accounting and regulatory changes will not help us or other Latin Americans with the problem they now have, which we increasingly share.

A solution, I believe has to come from the debtor countries themselves. This is why a precedent set by the U.S. Government in forgiving "official debt" would be helpful. The commercial banks, as noted earlier, have been extremely effective in their negotiations with the debtors, because they are relatively wellorganized and know precisely what they want. Only when the debtor countries, the other parties in the dispute, are able to act competently, either one-by-one or together, will real progress by made. That is why the Brazilian action suspending interest payments is a healthy development. A growing list of countries have defaulted on impossible obligations: Sudan, Liberia, Nicaragua, Bolivia, Ecuador, and Peru come to mind, as well as Brazil. Argentina shows encouraging signs, as well. The Philippine decision to pay part of its interest charges in what appears to be local currency ("PIN"s) is a good precedent, which can help other debtors. Others may follow this lead. They have nothing to lose. No net new money is going in and they can't get hurt worse than they are. If a "20% of export revenue" limitation were imposed by the debtor country itself, it would be relatively easy for the U.S. Government to accept.

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[1] European banks are much more flexible and ready to accept the idea of principal and interest reduction.

This Subcommittee hearing and the record it will generate could be a significant factor in steeling the will of some of the major debtors to take the steps they have to take. If they act, they deserve support and understanding from the U.S. Administration Congress, not opprobrium. In effect, they can help us out of the box which we have been painted into, along with them. As a practical matter, a broad reduction of claims against these countries, is probably only achievable when the countries themselves summon up the political will to act in their own behalf.

Looking down the road, there may eventually be some form of broad financial settlement, a sort of financial Congress of Vienna, where the U.S. Government participates and where these debts are reduced. The point of "African Relief -- Spelled D-E-F-A-U-L-T", an Op-Ed piece I wrote for the Wall Street Journal in November of 1986, which is attached, is that only when these countries act for themselves can the problems be resolved. Sympathy and understanding expressed by Members of Congress and the Administration can, however, help them along. When they act, it will be in our interest as well as in their own.

There is one last point which deserves making, although it seems so obvious and self-evident that one almost hesitates to mention it. Despite the skill with which the banks have defended their position since 1982, there does exist some mathematical chance that matters could go very wrong and that a serious financial crisis involving our commercial banks could develop. If such a crisis breaks, it will probably come in on cat-feet. We will not see it developing. The first sign of trouble will probably be sudden withdrawals of deposits from U.S. banks worldwide, and a sharp rise in the price of gold and the Swiss franc. Overnight, we will have another Continental Illinois situation on our hands, but much bigger. We will discover, perhaps too late, that a rolling and uncoordinated series of national defaults, perhaps marked by political unrest, is taking place.

Don't believe it can't happen. Even if the odds against it are long, it is a situation we do not want to encounter. We should take out insurance.

I urge you to ask pointed and direct questions in classified hearings as to precisely what the contingency plans of the Administration are to deal with this situation and to satisfy yourselves that they are adequate. Don't accept vague oral assurances. Insist on seeing formal, detailed, thorough written documents. These plans should be like military plans for the defense of the Aleutian Islands. If a crisis develops, the responsible parties must be ready to act together and to speak with tone voice. They should not have to improvise at sudden "crisis meetings." Since it is clearly in the interest of many international debtors to call"time-out" on their debt payments, there is some chance that they will actually do so. One of the biggest contributions you could make to the American people is to make sure that if this happens, contingency plans to support the U.S. banking system are well-laid. Hopefully, these plans exist and are updated regularly.

Thank you, Mr. Chairman.

THE WALL STREET JOURNAL FRIDAY, NOVEMBER 7, 1986

African Relief, Spelled D-E-F-A-U-L-T

By HENRY R. BEECK

Imagine the following conversation: "Quickfix" Kelly, a New York restructuring and workout specialist, is applying his expertise to the Third World. He has been sought out by, say, President Kenneth Kaunda, and has just arrived in Zambia.

"I am glad to see you in Lusaka, Mr. Kelly. My country is in desperate financial condition and I need an investment banker. You have experience with 'workout situations' in your country. Well, Zambia owes about $5 billion. You must not ask me how it was all borrowed. I do not know and nobody in my cabinet can or will remember. We needed oil. The copper price was high. We borrowed and somehow just spent the money. We don't even know where it went. Our records are poor. We were foolish. I am told we owe three or four hundred million dollars of interest this year. Then there is principal to pay. We do not have it. We have negative balance of trade, negative balance of payments. The banks and the foreign governments bother me every week. My trained young people spend most of their time just responding to this problem. They should be out working."

'Just Like Mexico?'

"Would you say you're just like Mexico?"

"Mexico? Do you know nothing of Africa? They are rich, those Mexicans. The GNP per capita in Mexico is well over $2,000 a year, more than four times ours. And they have universities and educated people, computer technicians, artists, a huge economy. Africa is poor. We have no industrial plants. Nothing works here. No money is coming in. My country is grinding to a halt."

"Didn't you just get an IMF loan?"

"Mr. Kelly, more money is now going out of Zambia than is coming in. Yes, they lend us money, but all that goes to pay interest and principal, and a little more is always taken out besides. We are exporting hard currency now."

"That's what you get when you rely on your creditors for advice. In a work-out, they're your natural enemies."

"Eventually a dog runs to the end of his chain. Our population is growing, most of my people are illiterate, there is trouble with our access to the sea, and our raw materials don't bring in much cash. The other day some Americans came to complain that we were destroying our game parks and our tropical forests. They want me to spend our money to save forests for the world. We cannot buy spare parts to make our Yugoslav trucks work, let alone hire men to protect our parks. My young men do not understand the world left to them by their fathers. How do we get out of this desperate mess?"

"First, Mr. President, you must grow up and speak for yourself. Act in your own interest. Pay no attention to the World Bank, the IMF, the African Development Bank, or any commercial banks. Don't hope for help from the U.S. or European governments. They have their own problems and you are low on their list. Stop whimpering about your need for aid. You won't get it. Nobody has any money for you. And stop saying 'desperate.'"

"Forgive me, but I get emotional. What do I do?"

"Default. Bankruptcy. Don't pay another dollar or pound or kwacha. Nothing."

"But that's unthinkable. The World Bank loans and IMF loans are, well, sacred, I am told."

"Rubbish. That's what the IMF and the World Bank bureaucrats tell you. A private company in your condition in the U.S. or the U.K. would have declared bankruptcy years ago. You need protection from your creditors. If you default, you will immediately recapture $400 million of interest that you will not have to pay. In effect, Sudan has done it. Same with Bolivia. Peru has more or less done it. Mexico scared the banks so much they haven't had to do it yet."

> *"But they'll cut off the money . . ."*
>
> *"So what. You're exporting hard cash now. You'll immediately be ahead of the game."*

"We'd never get away with it."

"Nonsense. Here's what you do. First, move every dollar, yen, D-mark, pound or Swiss franc you can lay your hands on into Zambia, or into a Southeast Asian bank, which I will arrange for you. Then call in all your creditors together at short notice, governmental and nongovernmental, and announce that as of that instant no more principal or interest will be paid. Make sure the World Bank and the IMF get told with the rest. No special treatment. They will all protest, of course. You will be firm. If they are impolite you will detain them until the first plane out of Lusaka. That always has a calming effect on Western businessmen. Be courteous and sad and regretful . . . but don't give an inch."

"But they'll cut off the money . . ."

"So what. You're exporting hard cash now. You'll immediately be ahead of the game. What you care about is supplier credits. You have to be able to pay for spare parts, and you're having trouble doing that now. Bank debt will just have to wait."

"How will we export our copper?"

"Greed is a wonderful thing, Mr. President. There are a lot of banks to which you don't owe money. You will announce a new certificate, the Red Kwacha, to certify precedence and seniority over all previous debts. Various banks will appear, I guarantee, eager to do secured trade financing in Red Kwacha at a few points over Libor. And within months the World Bank will be offering you 'soft' IDA loans again. You have some political bargaining power, you know."

"The East Germans were here the other day . . ."

"Well, you'll take help from anywhere you can get it, although they don't have much money, either."

"But we will be outcasts in the world financial system."

"I don't care about the system and you shouldn't either. You have real problems. Incidentally, I called my friends in Peru before coming here. The phones work. Ships come and go. It's no worse than it was. By the way, Alan Garcia is very popular in Peru. Are you ever going to have elections?"

"Would this be a long-term solution? Would the debt go away just that easily?"

"Yes. You cannot pay it. Everyone knows that. If you say you won't, it will have gone away. Debt is not sacred. The U.S.S.R. defaulted, China defaulted, American states defaulted, the Penn Central and WPPSS defaulted. Default is as capitalist as apple pie. Remember, this is not a solution in itself, but it will give you time to reorganize Zambia. I have some ideas about that, incidentally. But you can never get anywhere so long as this load of debt is slung under your neck. If you ever want foreign investment you have to get rid of it."

"How can the international banks and the governments accept this? They will be outraged."

"They will collapse like paper bags. What can they do? Hire mercenaries? They give you nothing now but grief. They are actually extracting hard currency from you. Believe me, you will be doing them a favor, for the debt is uncollectible anyway. Better we clear it away now and give your people a chance to move forward. That is in everybody's interest, for otherwise in 10 years your problem will be much worse."

'We Were Taken In'

"Mr. Kelly, you ask so much of me. Won't you go home, plead our case, get the World Bank and the IMF and the governments and the banks to forgive our debts? We can never pay and they know that. It would be so much easier for them to be generous. We are poor. Church groups will speak for us. Sen. Bradley is our friend. We were taken in by those loan officers, we . . ."

"You're sniveling again, Mr. President. Nobody likes weakness and in my country charity goes to voters first, like farmers in Indiana. It takes some nerve to tell a U.S. official to voluntarily write off taxpayers' money. And smart young bank officers don't get ahead by creating bad loans. They certainly aren't going to set a precedent that might be used against them by Mexico for the sake of Zambia. This is your problem, not theirs. You're busted. They're not. So do something. Let's get your minister of finance in here and set up a meeting with your creditors next week."

"But my minister of finance is at the Paris restructuring."

"Get him back here. He won't need to spend so much time in Paris after this. I'll be there to help you say the words in the right way. Workouts tend to get a little frank. My fee is 1% of the cash I save you annually. What do you say, Mr. President? Do we have a deal?"

Mr. Beeck is a New York investment banker with foreign experience.

STATEMENT OF DR. RICHARD WEINERT, PRESIDENT, LESLIE, WEINERT & CO., INC., NEW YORK, NY

Dr. **Weinert**. Thank you, Mr. Chairman, for this opportunity to appear and to be joined by such distinguished witnesses.

The debate over whether Third World countries need debt relief as a part of their debt restructuring has been overtaken by events. For the past several years, analysts have differed whether Third World countries were insolvent or merely illiquid, and whether rescheduling principle, while granting new loans tied to keeping current in interests payments would be adequate. Like most theoretical disputes, this was inconclusive. Meanwhile, policy followed the cautious route of doing less rather than more, of using existing tools and institutions rather than searching for new ones.

This has not been all bad. While there has been no improvement in such key ratios as debt-to-GNP, debt-to-exports or debt service, U.S. banks have taken advantage of the passage of time to increase their capital so they can better withstand financial shocks than they could have five years ago.

They have also benefitted from substantial net capital flows from Third World countries, which have contributed to high profitability. Debtor countries have suffered, but at least have played out the conventional option and so have a moral shield against the charge of financial irresponsibility.

But the line has nearly run out on this approach. Consider two things. First, the list of countries which have suspended interest payments has grown, and in Latin America that now includes Brazil, Ecuador, Peru, Bolivia, Cost Rica, Honduras, and Nicaragua. The number of such countries has ebbed and flowed, but the trend has been to increase.

Second, a secondary market has developed which pays this debt. While very small and exotic, only three years ago, it has grown to a respectable size of some $6 billion last year and continues to grow rapidly. While many small independent firms are active in this market, so are some of our largest and most prestigious financial institutions, such as CitiBank, Bankers Trust, Morgan, Shearson American Express, Maryland, et cetera. This market is nonpolitical, nonideological, dispassionate, and not tied to any position on debt relief.

It values Mexican debt at 59 cents on the dollar, Argentina at 63, Brazil at 65, Ecuador at 57, and so on.

This constitutes the clearest possible sign that holders of the debt and those willing to purchase it do not believe it can or will be paid in full at contracted interest rates.

Debt relief is thus here upon us. There are many kinds of debt relief, and one of the important side effects of the debate over whether debt relief was necessary is that it suppressed a consideration of what role some kind of debt relief can play in a successful debt restructuring. Successful debt restructuring must achieve two principal goals. First, it must protect the financial system against undue losses or a loss of confidence. Second, it must promote growth in debtor countries so they can recover, buy U.S. goods, develop democratic and stable politics, and repay their debts.

To achieve these two goals, a successful debt restructuring requires four elements, of which debt relief is one. First are policy reforms. Second, there must be belt-tightening. But these are not enough. There must also be two other ingredients to provide the incentives and rewards for adopting those reforms and accepting that belt-tightening.

One is new money targetted for growth; the other is debt relief on old debt. The price for debt restructuring is a textbook case of how these four elements intersect. In that instance, management changes produce policy reforms. Workers tighten their belts through salary reductions. The government provides new money for guarantees on new debt, thus assuring access to capital markets so production would not be impeded by capital shortages. Creditors provided debt relief by rescheduling principal, below market interest rates and converting some debt into forms of equity.

The key point is that none of these four elements was undertaken in isolation. They were part of a coherent package in which debt relief was the last element to be put in place, but one without which the rest of the package would not have held together. Some of these elements are already present with respect to Third World debt. The debtor countries have learned how to make policy reforms and have already begun to make them. Belt-tightening or austerity is a fact of life in all debtor countries and is widely understood to be a necessary component of an adjustment package.

But we need the other two elements—new money for growth and debt relief—to provide the incentives and rewards for the policy reforms and belt-tightening which are clearly necessary. There has been some public sector leadership.

Secretary Baker has provided some initiatives to spur more lending by multilateral banks. These efforts should be continued and strengthened. More should be done through export agencies, like the Eximbank, which can have the dual positive effects of facilitating needed imports by debtor countries to help them grow and provide employment for their citizens and simultaneously help U.S. exports, thus providing growth and employment at home. New capital inflows can be facilitated through the expansion of existing guarantee programs or the innovation of new guarantee programs.

But the biggest missing ingredient is debt relief on old debt, and we need a combination of public sector leadership and cooperation by creditors to provide this. Debt relief should not be unconditional or across the board. On the contrary, it should only be contemplated in the context of the other elements referred to earlier and can only be considered on a case-by-case basis. But the other elements of policy reform, belt-tightening and new capital flows will not be adequate or politically feasible unless creditors play their part through contributing some debt relief.

The major questions are what kind of debt relief to provide and how to decide on levels and timing. I believe the most appropriate form of debt relief is through interest rate reductions in which the principal is left undisturbed.

With few exceptions, there is no need to write off principal, but many debtor countries do need interest rate relief for some period which would reduce their cash flow outlays and permit them to devote more of their export earnings and other capital inflows to growth-oriented policies.

These policies will have a direct benefit to the U.S. since they will result in increased purchases of U.S. goods, as well as the indirect benefit of strengthening the economies and political systems of friendly nations.

The secondary market for Third World debt provides some signals of degrees of debt relief needed by different countries and suggests a mechanism to provide it. The mechanism could be a swap: government-backed bonds for Third World debt. A public entity, existing or newly formed, could offer to swap its bonds for debts of troubled debtors. The interest rate on these bonds would be lower than on the debt and the savings passed on to debtor countries. The discounts of Third World debt prevailing in the secondary market could be used as a guide to how much interest rate relief should be granted. For example, Argentina's debt is currently offered at around 63 percent of face value. In today's market, a government 15-year dollar bond with an interest rate of 3.75 percent would have a similar price.

Mexico's debt is currently traded for roughly 59 percent of its face value, approximately equivalent to the price of a government 15-year bond with an interest rate of 3.25 percent. The public entity would then offer to issue its bonds with those interest rates and swap them on a one-for-one basis with banks. It would offer a 3.75 percent bond for Argentine debt and 3.25 percent bonds for Mexican debt.

The bonds issued would have the same face value as the debt for which they were exchanged, and so there would be no change in the principal value of debt outstanding.

The rate on the government bonds then would depend on the value of the specific country debt for which they are swapped. This would preserve differences among countries and concentrate assistance where it is needed most. Debt of better-off countries sells for higher prices in the secondary market and would be exchanged for bonds with higher interest rates than debt of worse-off countries whose debt trades at much lower prices. The applicable interest rates on the bonds would then be passed on to the corresponding countries, who would receive no reduction in the total amount owed, but an immediate reduction in cash outflows since the applicable interest rate would be much lower than at present.

It is important to emphasize that this form of debt relief is not a substitute policy reform for belt-tightening. Rather, it is an incentive to adopt the difficult measures needed. It releases funds which are currently going toward interest payments to be used to promote growth, together with other new monies provided from other sources.

Some have argued that if countries obtain debt relief in any form which cause losses to banks, they would be cut off from credit markets for a generation or two. I doubt this. One might look at other successful debt restructurings, such as Chrysler, for a counter-example.

Banks give loans not as a reward for past good behavior, but as a vote of confidence in the future. Countries now are cut off from credit markets because, although they have behaved well, their future is cloudy. The irony is that the debt burden itself is part of what clouds the future, and easing it can make it brighter. Banks which swap Third World debt for low interest rate bonds would suffer reduced interest income in future years, but they would also strengthen their balance sheets by replacing uncertain assets with riskless ones.

In times of doubts about the soundness of banks and lowered credit ratings, many banks might find this an attractive trade-off. Regulators and accountants should facilitate such a swap with supportive treatment. Congressional action may be appropriate here.

The basic question is whether banks would be able to book the new lower yielding bonds at the same value as the loans they are giving up. Current treatment would probably require banks to book a loss, even though they are obtaining a better asset and thus strengthening their balance sheet. This is illogical, and special treatment should be devised to permit banks to treat the new bonds at face value, recognizing their lower market value over time through lower interest income.

I have one more paragraph. Shall I continue?

Senator BRADLEY. Please go ahead.

Dr. WEINERT. Debt relief in this form or some other form must be an integral component of successful debt restructurings, to achieve the dual goals of protecting our financial system and restoring growth in Third World countries.

The economic and political gains extend far beyond banks' balance sheets and balance of payment statistics. They go to the heart of crucial issues of employment and stability and well-being of citizens in debtor countries and in ours.

Senator BRADLEY. Thank you very much, Dr. Weinert, Dr. Bailey, and Mr. Breck. I appreciate your testimony very much. What I would like to do is ask just a few questions, if I could.

[The prepared written statement of Dr. Weinert follows:]

Testimony of Dr. Richard S. Weinert
President, Leslie, Weinert & Co., Inc.
New York, New York

United States Senate Committee on Finance
Subcommittee on International Debt
April 6, 1987

Summary

The debate over whether third world countries need debt relief as a part of their debt restructuring has been overtaken by events. For several years, banks have rescheduled principal and lent new money so countries could keep current on interest payments. But key ratios of debt/GNP and debt/exports have not improved and the line has run out on that approach.

A successful debt rescheduling would include four elements, of which debt relief is one. They are: policy reforms, belt tightening, new money and debt relief. The first two are already in place. New money should be provided by the public sector through multilateral banks and export agencies. Debt relief should be provided on existing debt by private banks. Debt relief should only be provided on a case by case basis, as part of a coherent overall program embodying the other three elements.

Debt relief should take the form of reduced interest rates, not reduction of principal. A public entity, either existing or newly formed, should offer banks its bonds at below market rates in exchange for the debt of selected countries. The lower interest rates would be passed on to the debtor countries, thereby giving them substantial savings in foreign exchange outlays. Debtor countries would then be able to import more from the United States, improving our trade balance and increasing employment. The amount of interest rate relief would be suggested by the prices at which the debt of different countries was selling in the secondary market.

Banks should be permitted to recognize their implicit losses slowly through reduced interest income, rather than immediate write-offs. Regulators and accountants should facilitate favorable treatment of this exchange and Congressional action in this regard might be appropriate.

The debate over whether third world countries need debt relief as a part of their debt restructuring has been overtaken by events. For the past several years, analysts have differed whether third world countries were insolvent or merely illiquid, and whether rescheduling principal while granting new loans tied to keeping current on interest payments would be adequate. Like most theoretical disputes, this was inconclusive. Meanwhile policy followed the cautious route of doing less rather than more, of using existing tools and institutions rather than searching for new ones.

This has not been all bad. While there has been no improvement in such key ratios as debt/GNP, debt/exports or debt service, U.S. banks have taken advantage of the passage of time to increase their capital so they can better withstand financial shocks than five years ago. They have also benefited from substantial net capital flows from third world countries, which have contributed to high profitability. Debtor countries have suffered, but have at least played out the conventional option and so have a moral shield against the charge of financial irresponsibility.

But the line has nearly run out on this approach. Consider two things. First, the list of countries which have suspended interest payments has grown, and now includes Brazil, Ecuador, Peru, Bolivia, Costa Rica, Honduras and Nicaragua. The number of such countries has ebbed and flowed, but the trend has been to increase. Second, a secondary market has developed which trades this debt. While very small and exotic only three years ago, it has grown to a respectable size of some $6 billion last year, and continues to grow rapidly. While many small independent firms are active in this market, so are some of our largest and most prestigious financial institutions, such as Citibank, Bankers Trust, Morgan, Shearson American Express, Merrill Lynch, etc. This market is non-political, non-ideological, dispassionate and not tied to any position on debt relief. It values Mexican debt at 59 cents on the dollar, Argentina at 63, Brazil at 65, Ecuador at 57, etc. This constitutes the clearest possible sign that holders of the debt and those willing to purchase it do not believe it can or will be paid in full at contracted interest rates. Debt relief is thus here upon us.

There are many kinds of debt relief. One of the unfortunate side effects of the debate over whether debt relief was necessary is that it suppressed a consideration of what role some kind of debt relief can play in a successful debt restructuring.

Successful debt restructuring must achieve two principal goals. First, it must protect the financial system against undue losses or a loss of confidence. Second, it must promote growth in debtor countries so they can recover, buy U.S. goods, develop democratic and stable politics, and repay their debts.

To achieve these two goals, a successful debt restructuring requires four elements, of which debt relief is one. First, are policy reforms. Second, there must be belt tightening. But these are not enough. There must also be two other ingredients to provide the incentives and rewards for adopting those reforms and accepting that belt tightening. One is new money targeted for growth; the other is debt relief on old debt.

The Chrysler debt restructuring is a textbook case of how these four elements intersect. In that instance, management changes produced policy reforms. Workers tightened their belts through salary reductions. The government provided new money through guarantees on new debt, thus assuring access to capital markets so production would not be impeded by capital shortages. Creditors provided debt relief, by rescheduling principal below market interest rates and converting some debt into forms of equity. The key point is that none of these four elements was undertaken in isolation; they were part of a coherent package, in which debt relief was the last element to be put in place, but one without which the rest of the package would not have held together.

Some of these elements are already present with respect to third world debt. The debtor countries are willing to undertake policy reforms, and have already begun to make them. Belt tightening, or austerity, is a fact of life in all debtor countries, and is widely understood to be a necessary component of an adjustment package. But we need the other two elements, new money for growth and debt relief, to provide the incentives and rewards for the policy reforms and belt tightening which are clearly necessary.

There has been some public sector leadership. Secretary Baker has provided some initative to spur more lending by multilateral banks. These efforts should be continued and strengthened. More should be done through export agencies like the Eximbank, which can have the dual positive effects of facilitating needed imports by debtor countries to help them grow and provide employment for their citizens, and simultaneously help U.S. exports, thus providing growth and employment at home. New capital inflows can be facilitated through the expansion of existing guarantee programs, or the innovation of new guarantee programs.

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The major questions are what kind of debt relief to provide, and how to decide on levels and timing. I believe the most appropriate form of debt relief is through interest rate reductions, in which the principal is left undisturbed. With few exceptions, there is no need to write-off principal. But many debtor countries do need interest rate relief for some period, which would reduce their cash flow outlays, and permit them to devote more of their export earnings and other capital inflows to growth oriented policies. These policies will have a direct benefit to the U.S., since they will result in increased purchases of U.S. goods, as well as the indirect benefit of strengthening the economies and political systems of friendly nations.

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The discounts of third world debt prevailing in the secondary market could be used as a guide to how much interest rate relief should be granted. For example, Argentina's debt is currently offered at around 63 percent of face value. In today's market, a government 15-year dollar bond with an interest rate of 3.75 percent would have a similar price. Mexico's debt is currently traded for roughly 59 per cent of its face value, approximately equivalent to a government 15 year bond with an interest rate of 3.25 percent. The public entity would then offer to issue its bonds with those interest rates and swap them on a one-for-one basis with banks. It would offer its 3.75 percent bonds for Argentine debt, and its 3.25 percent bonds for Mexican debt. The bonds issued would have the same face value as the debt for which they were exchanged, and so there would be no change in the principal value of debt outstanding.

The rate on the government bonds, then, would depend on the value of the specific country debt for which they are swapped. This would preserve differences among countries and concentrate assistance where it is needed most. Debt of better-off countries sells for higher prices in the secondary market and would be exchanged for bonds with higher interest rates than debt of worse-off countries, whose debt trades at much lower prices. The applicable interest rates on the bonds would then be passed on to the corresponding countries, who would receive no reduction in the total amount owed, but an immediate reduction in cash outflows, since the applicable interest rate would be much lower than at present.

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Some have argued that if countries obtained debt relief in any form which caused losses to banks, they would be cut off from credit markets for a generation or two. I doubt this. One might look at other successful debt restructurings, such as Chrysler, for a counter example. Banks give loans not as a reward for past "good" behavior, but as a vote of confidence in the future. Countries now are cut off from credit markets because although they have "behaved" well, their future is clouded. The irony is that the debt burden itself is part of what clouds the future, and easing it can make it brighter.

Banks which swapped third world debt for low interest rate bonds would suffer reduced interest income in future years, but they would also strengthen their balance sheets by replacing uncertain assets with riskless ones. In times of doubts about the soundness of banks and lowered credit ratings, many banks might find this an attractive trade-off.

Regulators and accountants should facilitate such a swap with supportive treatment. Congressional action may be appropriate here. The basic question is whether banks would be able to book the new lower-yielding bonds at the same value as the loans they are giving up. Current treatment would probably require banks to book a loss, even though they are obtaining a better asset, and thus strengthening their balance sheet. This is illogical, and special treatment should be devised to permit banks to treat the new bonds at face value, recognizing their lower market value over time through lower interest income.

Debt relief, in this form, or some other form, must be an integral component of successful debt restructuring, to achieve the dual goals of protecting our financial system and restoring growth in third world countries. The economic and political gains extend far beyond banks' balance sheets and balance of payment statistics. They go to the heart of crucial issues of employment and stability and well-being of citizens in debtor countries and in ours.

Senator **Bradley**. What do each of you see as the main problem with an approach to the debt issue that relies almost exclusively on new money? Dr. Weinert?

Dr. **Weinert**. Providing new money doesn't do anything for the debtor country. What it basically does is increase its debt and continue to provide—and therefore increase the burden of future debt service, while continuing the outflow.

And so, it doesn't do anything in a financial sense. In a political sense for those countries, it is actually negative because there is a tremendous awareness and sensitivity within those countries that they have enormous economic problems today because of an excessive debt buildup in the past; and what that set of policies does is continue the debt buildup, which is generally perceived as the cause of the problem.

In that sense, it is politically negative and in a sense undermines a variety of other policy reforms which are probably needed and which tend to go along with the proposed new money.

Senator **Bradley**. Dr. Bailey?

Dr. **Bailey**. I would agree with everything that Dick has said on that, except that I would add that, if coupled with the other elements of the kind of program that he is talking about and increased flow of development funding on a long-term basis at concessional rates of interest—the kind of thing that is or at least should be done by the World Bank, the IDB and so on—would be a helpful element to the program.

Senator **Bradley**. Mr. Breck?

Mr. **Breck**. I am not so happy about developmental funding. I am for free enterprise; I am a capitalist. And I believe you have to clear away a lot of the debt before private people will invest their money and their time in their own countries, let alone outside investors. That is why you have to get rid of a lot of the debt.

Would I, as an investor, put $10 million into Argentina, looking at this problem? I don't think I would. And if you clear away a lot of the debt and if the countries follow sensible policies, you are going to find capital flooding in to some of these countries, which are intrinsically very vibrant, strong economies; but you have to clear away the senior debt first. In the Chrysler analogy, what you have to do first is convert a lot of that senior debt to equity or subordinated forms of obligations. You leave that senior debt out there, and investors won't put equity money in.

Senator **Bradley**. If I could just followup on what you said, you said that you wouldn't put any money in Argentina, given the present circumstance?

Mr. **Breck**. Certainly not.

Senator **Bradley**. Why? How does the existence of the debt and increasing the amount of the debt—which essentially is what new money does—erode investor confidence?

Mr. **Breck**. It is a prior claim of countries' foreign exchange. If I want to put dollars in, I want to get dollars out. I live in New York City, and I spend dollars. I want to make sure that if I go to the Central Bank and say I have made 25 percent return on equity, that I can get dollars for it. You can do that in the United States today. I want to be able to do it in Argentina.

Now, if you have a permanent debt crisis, you go to the bank and there is a line of 700 people there and you get at the end of it; I mean, that is what a debt crisis is. You can't get foreign exchange, and also nobody wants to invest in a country which is subject to the kind of political crisis which this debt crisis creates. It creates it—as somebody said—every six months. I think it was you, Norman. You said that every six months you have a debt crisis. Who wants to invest in that situation?

You need financial stability and political stability. You have that and money will pour into Argentina.

Senator **Bradley**. So, not only does it erode investor confidence by putting you at 700th in the line, but you say there is a political component as well?

Mr. **Breck**. Absolutely.

Senator **Bradley**. That creates a sense of instability and uncertainty. The question is, in that kind of political climate: What are the chances for economic reform? Dr. Bailey?

Dr. **Bailey**. Well, I mean, it is obvious that the more that the creditors—governments and banks—are perceived as being the problem, as opposed to part of the solution of the problem, whatever they want those countries to do will be perceived as being part of imperialistic attempts to create changes that, first of all, go unrewarded—as I pointed out—I mean, it doesn't make any difference if they make them or they don't make them with reference to the attitude of the creditors.

And second, they are imposed from the outside, which is always something that is difficult for a country to swallow. But I will say that one of the worst dangers of this debt situation, in my opinion, is that mentalities have begun to change in many of these countries. Now, they are realizing that a bloated public sector and huge internal and external deficits and so on and so forth are not a good idea, and a lot of things have taken place. A lot of policy changes have taken place; but if this kind of thing continues, all of that progress—mental progress, psychological progress—that has been made, as well as the progress toward democracy, as Senator Sarbanes pointed out, is going to be reversed.

And all you have to do is look at the triumphal reception of Alan Garcia in Mexico, when he went up there recently for a visit, to——

I mean, it was mentioned that for some investment bankers he may be a hero. He is certainly a hero to the Mexican people, and much more so than their own government which, of course, has continued this process which has been so unsuccessful in the past.

Senator **Bradley**. Yes. Dr. Weinert?

Dr. **Weinert**. I don't think we are facing quite the chasm that some of the immediately preceding remarks have painted. I don't think that, for example, the policy reforms that have been undertaken are about to be reversed because of lack of progress in the debt problem. I think we are in a situation in which we want to encourage those reforms to occur more deeply and more rapidly. I don't think they are going to get reversed in any case because I think they are widely perceived to be desirable on their own merits.

And I think that is a very, very good thing for them and for us. What I think we should be doing in the public sector and from the private creditors is to encourage those things—those reforms—and encourage them to be done in a more rapid and a more deep-seated way; and I think that some form of debt relief through interest rate reductions is needed.

I think another point that needs to be stressed in the context of this discussion is that there needs to be some kind of conditionality attached to any debt relief put forward because you have got to address the moral hazard problem that, I think, Senator Sarbanes referred to indirectly, and that is at the center of the consideration of this kind of approach and an objection which is commonly made to it, namely that you seem to be rewarding the worst-behaved countries.

And the answer to that, first of all, is to consider these things on an absolute case-by-case basis and, second, to contemplate debt relief programs only in the context of a larger program, which will encompass the policy reforms that you desire and a certain degree of austerity and belt tightening, which is appropriate because these countries initially in putting on too much debt spent a lot of it on consumption. And so, it is not inappropriate or inequitable that there be a certain amount of belt-tightening and austerity now.

So, I think you have to look at this as a kind of integrated program in which debt relief is granted or contemplated in the context of a larger overall debt restructuring and economic reform program.

Senator **BRADLEY**. Yes. The question is not simply the space to grow through interest rate relief or debt relief, but it is also the will to take the reform in the effected country. And the question is whether a package of interest rate relief— Where do you draw the balance between enough time so that if you are the private investor, Mr. Breck, you know that the thing is not going to be tied over for 15 months causing another political crisis, but short enough so that there is pressure on the elected leader to take the touch policy choices? Where is the balance between enough pressure for the tough policy choices for growth domestically and enough space so that, as an investor, you invest because you think that the financial picture has been stabilized?

Mr. **BRECK**. I don't know what the answer is to that. It is a very confusing, messy problem, and you can never tell when private investors are going to invest. Markets are notoriously unpredictable. I don't agree with anything that has been said to my right here. I just think that nothing will happen if we sit here with this kind of discussion and we will have theoretical formulae about how it might be done and we speak in a third party way. We say ways must be found, or better solutions must be devised; and nothing is going to happen. That is why the Alan Garcia approach is, I believe, the way we will get out of this mess, because those people are the ones whose futures are at stake.

Senator **BRADLEY**. You raised the other aspect of this. For a debtor country, the idea of some debt relief might not be the beginning. The beginning might be default.

Mr. **BRECK**. That is what I think is happening. And I think all you have to do is pick up a newspaper, and you see on the front page every day an indication that another country is considering this option. It is certainly not the preferred solution, and perhaps Dr. Weinert's solution is the preferred one; but I am afraid that, given our political system and given the wide number of conflicting interests, what we will do is publicize this problem, but we will not—as a practical matter—be able to do anything about it, either on the executive side or on the legislative side. And my own feeling is that the solution probably will come from the Third World itself.

Should it come from us, in the best world, possibly? Yes. But as a practical matter, I don't think that is going to happen. That is why I think the intellectual support and sympathy which could be expressed by influential people in the United States is very important.

Alan Garcia wants to know that people do not regard him as a lunatic.

Senator BRADLEY. So, your point is that what the U.S. should do is accommodate the unilateral actions of Third World countries?

Mr. BRECK. Yes. I believe that, but mind you, there may come a time when we have to do something about it. If we get a breakdown of the financial system, if we get a system of rolling and uncoordinated international defaults—and we could—we will have to act; and the information base you are building now will be very important, if we are to build on that. It is very difficult to imagine how Secretary Baker, for example, could take any significant step forward more than the Baker Plan in this regard. He is a central banker. He is constrained by his first responsibility, which is to protect the nation's banking system; exactly the same for Paul Volcker. And I think they are in a very difficult position. I am sure Secretary Baker knows what the truth is, but it is very difficult for me to see how he could put real pressure on the commercial banks, for example. That is just not a role he can effectively play.

Senator BRADLEY. Do either of the other two of you disagree or agree? Dr. Bailey?

Dr. BAILEY. Oh, I very strongly disagree with that last statement. In the first place, Jim Baker is not a central banker. Second, he has the whole health of the financial system of the United States under his care, rather than just the banking system. Paul Volcker is, of course, a central banker, and his concern is the commercial banking system; and therefore, the two have different responsibilities and they have, to some extent, similar concerns, but they also ought to have to some extent differing concerns.

The problem of encouraging uncoordinated or even coordinated, for that matter, defaults all over the place is that the American banking system is extremely vulnerable with reference to its domestic exposure. That is, after all, what put Continental Illinois under and is at least as important as its external exposure with reference to the situation that Bank of America is in at the present time.

It may well be that we get an overall financial and banking crisis, but I really don't think that we ought to encourage it. And the fact that things can be done in a cooperative and coordinated fashion is not only indicated by the kinds of ideas that Dick Weinert was suggesting, which I strongly approve of—in fact, wrote about all the way back in the beginning of 1983—but also what the Japanese banks are doing now.

And I repeat that that should be studied very carefully by everybody involved with the situation.

Senator BRADLEY. Dr. Weinert?

Dr. WEINERT. Yes.

Senator BRADLEY. Do you have any comment, defense, addition, insight—all of the above?

Dr. WEINERT. I agree with the thrust of what Norman was just saying. We clearly don't want to have a banking crisis, and we clearly don't want to have widespread defaults and repudiation of the Third World. What I think public policy ought to be aimed at is recognizing that there is a serious problem which is not being well addressed at the present time, to try to find an accommodative way which would serve the interests of all parties in precisely avoiding such a crisis.

Senator BRADLEY. Might one call what you are describing as managed default?

Dr. WEINERT. Yes, but I wouldn't want to say managed default; I would want to say——

Senator BRADLEY. I don't want to say it, either.

Dr. WEINERT. No. I would want to say managing a successful debt restructuring. I think what Henry was saying earlier about the need to do something about the senior debt is right, and that the thrust of what I was saying as well. You have got to do something about the senior debt, to provide some kind of interest rate relief on old debt in order to facilitate and help create the conditions under which both new debt and investment would flow. I think that point is central to what I am saying and where I would coincide.

I don't think, on the other hand, we should be encouraging unilateral actions precisely because that heightens confrontation, which is what we want to avoid.

Senator BRADLEY. Yes.

Dr. WEINERT. On the question of investment flow, you raised clearly the very key sensitive issue to which I don't think there is a clear answer. How do you decide how long a period you need, how much relief should be provided? This, I think, has to be worked out in a clearly case-by-case basis with countries and multilateral agencies and private creditors and other interests represented.

The key thing though, I think, is that we are not facing a chasm. It is not an all or nothing situation. It is not that no investment is flowing; in fact, some investment is flowing into countries. They are not going into Peru, but they are going into Mexico, through the debt equity conversion programs. The problem with that is that the implicit rates of return that are demanded by private creditors are very, very high because of the burden of the debt overhang.

It is not a question of if you can solve a debt flow; if you can alleviate the debt burden, more investment will flow with a lower implicit return, which will be beneficial for everybody.

Senator BRADLEY. If I take your suggestion, your plan—which you have written eloquently about in addition to testifying today—of policy reform, belt tightening, new money, and debt relief, when you get to the debt relief portion, you are suggesting that the market value of a loan be swapped for bonds whose interest rates reflect the market value, i.e. at a lower interest rate, and that this bond be backed by the full faith and credit of the United States Government. Is that correct?

Dr. **Weinert**. Or some multilateral agency.

Senator **Bradley**. All right. In other words, you think that the world banks credit is as good as the United States Government in this case?

Dr. **Weinert**. Effectively, it is, yes. Effectively, it is right now because of the culpable capital provisions on World Bank bonds.

Senator **Bradley**. Yes. So, how would the World Bank assume that responsibility? You think that it has sufficient capital to do that?

Dr. **Weinert**. No, you would need to have either a new facility created—and I think it should be a multilateral one as Senator Sarbanes said—or if done through the World Bank, which is easier because it is an existing institution, it would probably require either some modification of its rules or capital increase of the World Bank to provide for this kind of a guaranteed facility or a bond issuing facility.

Senator **Bradley**. Yes. Mr. Breck, one last question, and that is back to the problem of overindebtedness and whether overindebtedness in some countries might not be discouraging the development of broad-based equity markets? If you take Dr. Weinert's view that there has to be new money, that you think that new money is unlikely to come in the form that it came in the 1970s—direct bank lending—and that some will come through multilateral institutions but another possibility is through direct equity investment in the stock markets of various Third World countries, does overindebtedness impede the development and the enlargement of equity markets in Third World countries?

Mr. **Breck**. Absolutely. If you have an unhealthy situation in any country, the equity markets are not going to do well. Money won't come into any country where you have a difficult situation; I think that is self-evident.

Senator **Bradley**. Does anybody else have any comment about equity markets as a possible way to get capital into Third World countries. Yes, Dr. Bailey?

Dr. **Bailey**. If you can reduce the debt burden so that there is the possibility of growth and development—assuming that the appropriate reforms have taken place—and if you have the appropriate instruments which would have to be bearer instruments, the capital market is going to be an extremely useful method of bringing flight capital back into the country; and that should certainly be part of any kind of a program for resolving the problem, in my opinion.

Senator **Bradley**. Let me thank all three of you very much for your testimony. I think it has been very helpful, and I think that with the number of insights you have given that it will be very useful as we move forward. Thank you very much.

What I would like to do is declare a five-minute recess, and then the next panel will consist of Mr. James Hurlock, Partner of White and Case; Mr. Bernard Nossiter of New York; and Mr. Joel Wells, President of SunTrust Banks. So, please take your seats, and we will resume in about five minutes.

[Whereupon, at 11:00 a.m., the hearing was recessed.]

AFTER RECESS

Senator **Bradley**. Let me express my appreciation to the witnesses for the delay and let me begin by welcoming Mr. Hurlock to the committee, as well as Mr. Nossiter and Mr. Wells. Doctor Hurlock, there is a difference between what is on your testimony and what is on the nameplate; I would never make the error of calling someone who is a doctor a "mister" if he wanted to be called "doctor." [Laughter.]

And I don't know which of the two you want. So, Mister/Doctor Hurlock, it is your turn.

STATEMENT OF JAMES HURLOCK, PARTNER, WHITE & CASE, NEW YORK, NY

Mr. **Hurlock**. Thank you, Mr. Chairman. I have passed quite happily through 50-some years as 'Mister' and I propose to continue that way. I commend the subcommittee for holding these hearings on the international debt crisis. I would like to take the opportunity this morning to provide a perspective on the current status of the problem.

Since this crisis began in 1982, the position taken by the commercial lenders toward those developing countries which have encountered difficulties has been both natural and predictable, namely to adopt the strategy which as a matter of highest priority protects the earnings of those lenders. In the case of the United States, the strategy is imposed not least by the regulatory and commercial environment in which the lenders operate. Thus far, the position of the borrowing countries has been to honor their obligations to the fullest extent possible.

Unfortunately, the evolution of the world's economy in the last seven years, resulting in structural economic dislocations rather than mere liquidity crises, has defeated the efforts made on both sides. During these years, the commercial creditors have relied upon the IMF, originally conceived as a short-term lender of last resort to deal with liquidity crises, to impose necessary disciplines on errant developing economies. And the majority of debtor countries have accepted and attempted to meet the precepts of the IMF's standby and extended credit facilities. But the crisis which has evolved has exceeded the ability of the programs or the resources of the IMF to resolve these problems.

As the crisis deepened with increasing defaults in payment of interest as well as principal, American commercial lenders were obliged to increase their efforts to assure current payments of interest by providing what is euphemistically called "new money" or "fresh money" to close the gap. Eventually, the very participation of commercial lenders in the process became conditional upon receiving assistance in closing the gap from the IMF, the World Bank, AID, and other bilateral agencies. And increasingly the gap covered only funds sufficient to pay interest. Allocations for national working capital were squeezed out, and funds for growth evaporated.

It has been recognized that closing the gap was a short-term approach to the problem, but it was hoped on all sides that in the 12 to 18 month window covered not only by the recurrent reschedulings by commercial lenders but also by the succeeding IMF programs and the Paris Club arrangements, the economies of the debtor countries would recover or, at worst, other solutions could be considered at the expiration of the current rescheduling periods. In the interim, the maintenance of interest flows and earnings which they represented to lenders could be maintained.

In the process of closing the gap no one lender is willing to lend unless other institutions also extend credit. In the course of such negotiations, the developing country itself is relegated to the role of a mere observer, as the various lenders sort out the size and timing of their commitments.

As the international debt crisis deepened, the approach taken by multinational and commercial lenders became increasingly unresponsive to the problem, not necessarily as a matter of intention, but because the priorities of the parties increasingly had little to do with each other. Amid conflicting reports in the media to the effect that the debt crisis had ended, followed soon thereafter by failures by important debtor countries to meet their debt service obligations, the good will that is necessary to the solution of complicated economic problems evaporated and positions on all sides hardened. The confidence of the debtor countries in the medicine prescribed by the IMF waned, and the confidence of the lenders in either the ability or the determination of the debtor countries to pay their debts deteriorated sharply. The economic difficulties of the debtor countries produced in many cases increased domestic political instability, which in turn made it difficult for the governments of debtor countries to impose additional restraints on their economies. The ability of such countries to borrow medium term funds internationally literally evaporated, as lenders quite logically sought to reduce their exposures.

On all sides, it was understood that the debtor countries could only repay their obligations by stimulating growth in their domestic economies; but when most needed for this purpose, funds became unavailable and world trade contracted as the demand for raw materials and commodities, the economic foundation of many developing countries, fell sharply.

The approach of commercial lenders in the "gap financing" mode has been to act as "lenders of last resort" only after the debtor country has agreed to take draconian measures to reduce the need for external financing and all other sources of financing have been exhausted. Thus, the amount of so-called "new money" extended to a given debtor country by its commercial lenders has been calculated as the minimum amount that is required to allow the country to meet its debt service requirements at full market rates after adoption of austerity programs and the receipt of loans from official lenders. The country is expected to use whatever new loans it receives, whether from official lenders such as the World Bank or US AID or from commercial lenders, to pay interest on its debt as a priority item and to pay minimum amounts of principal to official lenders. Even those funds that are advanced by official lenders for specific development projects and programs are expected to be applied to current debt service payments, and the World Bank has been enlisted to supply structural adjustment loans.

The adherence to an approach premised on economic adjustment and gap financing has resulted in an excessively complicated web of agreements that made it virtually inevitable that the debtor country will experience problems with the timing or availability of funds from one or another lender which, due to the linkage of the groups of lenders, will result in all lenders suspending their agreement to provide "new money." A suspension of loans results in an interruption of financing flows to the country and in a series of time-consuming and expensive waivers and amendments in order to free up disbursements.

The debtor countries have almost uniformly surrendered growth and long-term development projects in order to meet short-term economic needs. The commercial lenders, with their heavy exposure to debtor countries and with little immediate prospect of recovering their principal, react primarily to market perceptions of their balance sheets and income statements and to obscure an inadequate regulatory and accounting principles which govern the treatment of these problems.

At approximately the time when the issue for many debtor countries became simply an inability to pay interest as it fell due, the Baker Plan was proposed. In short, the Baker Plan recognized that, with economic adjustment, the economies of debtor countries would have to grow, and to grow, such a economies would require medium term support from all members of the international lending fraternity and particularly the commercial lenders which were and are the largest participants. While perhaps right in concept, the Baker Plan was too late. The exposure of commercial lenders was too great, the health of the debtor countries was seen to be poor, and the lenders were already well advanced in disinvestment programs. The Baker Plan could not and has not worked. The Bank for International Settlements has documented this point in reporting that lending to developing countries, other than OPEC members, fell by $4.6 billion over the first nine months of 1986. And according to the World Bank, the total amount of debt service payments by developing countries in 1986 exceeded new lending by approximately $30 billion with the commercial lenders as the primary beneficiaries of this capital outflow. It is reminiscent of bleeding the seriously ill to improve their health.

As has been the case for some time for smaller debtor countries, larger countries have now acted on the proposition that there is insufficient foreign exchange available to meet interest payments when due on outstanding debt. Neither is there any real possibility that by adding to the debt either by borrowing new money or by capitalizing interest the still higher charges of interest resulting will be met. In effect, the patient is not recovering. The medicine has not worked. Brazil felt obliged to announce its moratorium on interest payments. The recent Mexican solution—while advertised as supporting growth—is already months late in funding and probably will never be fully funded. Even if it is, it is unlikely that the situation will not deteriorate further.

To improve the prospects for ultimate repayment of sovereign loans and restore stability to the renegotiation process, it would seem clear that alternatives incorporating a longer term approach to the problem must be explored. For sovereign borrowers, a long-term approach means avoiding the temptation of announcing a repudiation of external debt or completely abandoning domestic programs in favor of undisciplined inflation. For official and commercial lenders, a long-term approach means allowing debtor nations to pursue growth and development programs and agreeing to repayment schedules and interest rates that are within the country's ability to pay. Debtor countries and their lenders must work out sustainable annual debt service payments that allow the country to devote resources to stimulate economic growth, encourage exports and maintain adequate reserves as priority items so as to ensure a minimum level of long-term stability. The annual payment levels established could be adjusted upward if the country's economy performed better than anticipated. Above all, increases of debt should be avoided wherever possible.

Any number of formulas exist whereby the amount of interest the debtor nation would be required to pay in hard currency on a current basis could be limited to an amount which represents an acceptable proportion of available foreign exchange. To date, however, neither governmental nor commercial lenders have given serious consideration to such proposals on the grounds that, in the case of governments, the loans then become aid programs which have been anethema to the Paris Club; and in the case of commercial lenders, acceptance of less than a market rate of interest will force a massive write-down of loans and nonaccrual of interest under applicable regulations and will discourage lenders from providing any additional loans.

It is not at all clear under current accounting and regulatory rules what impact a below market rate of interest would have on the lenders' earnings and disclosure requirements. A more honest and open review of this issue is needed. The contention that reduced interest rates would jeopardize additional loan rings hollow since, as previously noted, the lenders' exposure to developing countries has been declining, even under the current strategy; and no real medium term finance is available to most debtor countries.

The relationships between official and commercial lenders also require honest and open review in a form in which the debtor nations are allowed to participate fully. The IMF and the World Bank should be seen not just as participants in gap financing but as independent institutions reasonably immune from national, political, or other pressures and able to indicate with authority when a debtor country is doing all that can be expected by way of adjustment without being obligated to accept additional debt which it will not be able to service.

Debtor countries should be free to use loans from official lenders for the purposes for which they were intended, instead of diverting the proceeds of such loans to pay interest on existing debt. What is needed, therefore, is an admission that the approach followed to date has not worked, and alternatives must be found which will permit debtor countries to remain responsible for their debt. Repudiation should not be their only choice.

While they should take all reasonable steps to adjust their economies to facilitate payments of interest and principal, the other participants in the process must accept new approaches which, if less profitable, will nevertheless contribute to the creation of viable economies which can again perform and become the sources of new and greater profits in the future. I hope that these hearings will contribute to the development of these new approaches.

Senator **Bradley**. Thank you very much, Mr. Hurlock. Now, Mr. Nossiter?

[The prepared written statement of Mr. Hurlock follows:]

THIRD WORLD DEBT: THE NEED FOR A NEW APPROACH

Statement by
James B. Hurlock
Managing Partner
White & Case

SUBCOMMITTEE ON INTERNATIONAL DEBT
COMMITTEE ON FINANCE
U.S. SENATE

April 6, 1987

Mr. Chairman, I commend the Subcommittee for holding these hearings on the international debt crisis. I would like to take the opportunity this morning to provide a perspective on the current status of the problem. Since the present crisis began in August, 1982 the position of the commercial lenders who are also the largest creditors to those developing countries which have encountered difficulties has been both natural and predictable -- namely to adopt a strategy which as a matter of highest priority protects the earnings of those lenders. Thus far the position of the borrowing countries has been to honor their obligations to the fullest extent possible. Unfortunately, the evolution of the world's economy in the last seven years resulting in structural economic dislocations rather than mere liquidity crises has defeated the efforts made on both sides.

During these years the commercial creditors have relied upon the IMF, originally conceived as a short-term lender of last resort to deal with liquidity crises, to impose necessary disciplines on errant developing economies, and the majority of debtor countries have accepted and attempted to meet the precepts of the IMF standby and extended credit facilities. But again the structural nature of the economic crisis which has evolved has exceeded the ability of the programs or the resources of the IMF to resolve these problems. Against this background of economic deterioration and an uncertain regulatory regime American commercial lenders have felt obliged to protect their earnings by adopting strategies which assure current payment of interest by debtor countries. When the debtor countries have been found unable to meet their interest payments, the response has characteristically been to find means of providing what is euphemistically called "new money" or "fresh money" to close the gap.

This money increasingly has been made available when the debtor has been found incapable of servicing its existing debt. It has been recognized that this was a short-term approach to the problem, but it was hoped on all sides that in the twelve-to-eighteen month window covered not only by the recurrent reschedulings by commercial lenders but also by the succeeding IMF programs and the Paris Club arrangements the economies of the debtor countries would recover or, at worst, other solutions could be considered at the expiration of the current rescheduling periods.

In these circumstances the preoccupation of multinational and commercial lenders became the closing of the current account payment gap for the next twelve or eighteen months. The problem had become too acute to provide for real "new money" to stimulate development. In such circumstances no one lender is willing to lend unless other institutions also extend credit. In the course of many negotiations the developing country itself is relegated to the role of a mere observer as the various lenders sort out the size and timing of their commitments.

As the international debt crisis deepened, the approach taken by multinational and commercial lenders became increasingly unresponsive to the problem, not necessarily as a matter of intention but because the priorities of the parties increasingly had little to do with each other. Amid conflicting reports in the media to the effect that the debt crisis had ended followed soon thereafter by failures by important debtor countries to meet their debt service obligations, the goodwill that is necessary to the solution of complicated economic problems evaporated and positions on all sides hardened. The confidence of the debtor countries in the medicine prescribed by the IMF waned, and the confidence of the lenders in either the ability or the determination of the debtor countries to pay their debts deteriorated sharply. The economic difficulties of the debtor countries produced in many cases increased domestic political instability which in turn made it difficult for the governments of debtor countries to impose additional restraints on their economies. The ability of such countries to borrow medium-term funds internationally literally evaporated as lenders quite logically sought to reduce their exposures.

On all sides it was understood that the debtor countries could only repay their obligations by stimulating growth in their domestic economies but, when most needed for this purpose, funds became unavailable and world trade contracted as the demand for raw materials and commodities, the economic foundation of many developing countries, fell sharply.

The approach of commercial lenders in the "gap financing" mode has been to act as "lenders of last resort" only after the debtor country has agreed to take draconian measures to reduce the need for external financing and all other sources of financing have been exhausted. Thus the amount of so-called "new money" extended to a given debtor country by its commercial lenders has been calculated as the minimum amount that is required to allow the country to meet its debt service requirements at full market rates after adoption of austerity programs and the receipt of loans from official lenders. The country is expected to use whatever new loans it receives, whether from official lenders such as World Bank or U.S. AID or from commercial lenders, to pay interest on its debt as a priority item and to pay minimum amounts of principal to official lenders. Even those funds that are advanced by official lenders for specific development projects and programs are expected to be applied to current debt service payments, and the World Bank has been enlisted to supply Structural Adjustment Loans.

The adherence to an approach premised on economic adjustment and gap financing has resulted in an excessively complicated web of agreements that make it virtually inevitable that the debtor country will experience problems with the timing or availability of funds from one or another lender which, due to the linkage of the groups of lenders, will result in all lenders suspending their agreement to provide "new money". A suspension of loans results in an interruption in financing flows to the country and in a series of time-consuming and expensive waivers and amendments in order to free up disbursements.

Ultimately the debtor country must surrender growth and long-term development projects in order to meet short-term economic needs. The commercial lenders, with their heavy exposure to debtor countries and with little immediate prospect of recovering their principal, react primarily to market perceptions of their balance sheets and income statements and to obscure and inadequate regulatory and accounting principles which govern the treatment of these problems.

At approximately the time when the issue for many debtor countries became simply an inability to pay interest as it fell due, the Baker Plan was proposed. In short the Baker Plan recognized that with economic adjustment the economies of debtor countries would have to grow, and to grow such economies would require medium-term support from all members of the international lending fraternity and particularly the commercial lenders which were and are the largest participants. While perhaps right in concept, the Baker Plan was too late. Lenders were already well advanced in disinvestment programs, given the seriousness of the debtor countries' problems. The Baker Plan could not be and has not been executed. The Bank for International Settlements has documented this point in reporting that lending to developing nations other than OPEC members fell by $4.6 billion over the first nine months of 1986, and according to the World Bank the total amount of debt service payments by developing countries in 1986 exceeded new lending by approximately $30 billion, with the commercial lenders as the primary beneficiaries of this capital outflow. The situation of many debtor countries is now one where there is insufficient foreign exchange available to meet interest payments when due on outstanding debt, and there is no real possibility that by adding to that debt either by borrowing "new money" or by capitalizing interest the still higher charges of interest can be met. In effect the patient is not recovering -- the medicine has not worked. The recent Mexican solution, while advertised as supporting growth, is already months late in funding and may never be fully realized.

To improve the prospects for ultimate repayment of sovereign loans and restore stability to the renegotiation process, it would seem clear that alternatives incorporating a longer-term approach must be explored. For sovereign borrowers, a long-term approach means avoiding the temptation of announcing a repudiation of external debt or completely abandoning austerity programs in favor of simply borrowing more money. For official and commercial lenders, a long-term approach means allowing debtor nations to pursue growth and development programs and agreeing to repayment schedules and interest rates that are within the country's ability to pay. Debtor countries and their lenders must work out sustainable annual debt service payments that allow the country to devote resources to stimulate economic growth, encourage exports and maintain adequate reserves as priority items so as to ensure a minimum level of long-term stability. The annual payment levels established could be adjusted upward if the country's economy performed better than anticipated.

Any number of formulas exist whereby the amount of interest the debtor nation would be required to pay in hard currency on a current basis could be limited to an amount which represents an acceptable proportion of available foreign exchange. To date, however, commercial lenders have not given serious consideration to such proposals on the grounds that acceptance of less than a market rate of interest will force a massive write-down of loans and non-accrual of interest under applicable regulations, and will discourage lenders from providing any additional loans. It is not clear under current accounting and regulatory rules what impact a below-market rate of interest would have on the lenders' earnings and disclosure requirements. A more honest and open review of this issue is needed. The contention that reduced interest rates would jeopardize additional loans rings hollow since, as previously noted, the lenders' exposure to the developing countries has been declining even under the current strategy and no real medium term finance is available to most debtor countries.

The relationships between official and commercial lenders also require honest and open review in a forum in which the debtor nations are allowed to participate fully. The IMF and the World Bank should be seen not just as participants in gap financing but as independent institutions immune from political or other pressure, able to indicate with authority when a debtor country is doing all that can be expected by way of adjustment without being obligated to accept additional debt which it will not be able to service. Debtor countries should be free to use loans from official lenders for the purposes for which they were intended instead of diverting the proceeds of such loans to service existing debt.

What is needed, therefore, is public recognition that the approach followed to date has not worked. An alternative must be found which will permit debtor countries to remain responsible for their debt. Repudiation should not be their only choice. While they should take all reasonable steps to adjust their economies to facilitate payment of interest and principal, the other participants in the process must accept new approaches which, if less profitable, will nevertheless contribute to the creation of viable economies which can again perform and become the sources of new and greater profits in the future. I hope that these hearings will contribute to the development of these new approaches.

STATEMENT OF BERNARD NOSSITER, JOURNALIST, NEW YORK, NY

Mr. NOSSITER. It is now clear that the crisis of Third World debt is no mere episode to be cured by still another restorative dose of austerity taken by borrowers. This has been the widely held remedy in Western financial circles, central banks, and the International Monetary Fund, soon after Mexico inaugurated the cycle of quasi-defaults in 1982.

The conventional banking wisdom held that if only Mexico, Brazil, and the others curbed consumption and budget deficits, devalued currencies and ended subsidies for bread, buses and other goods and services—but never weapons—their economies would magically right themselves, their exports would boom, the heavy burden of debt would vanish.

This, of course, was nonsense. Latin America, for example, has endured a 10 percent fall in per capita income since the Mexicans fell from grace; investments dropped by a third; unemployment in some countries is above 50 percent. None of them, as far as I know, feel any better for their austerity programs. The financial authorities, it should be recalled, offered similar deflationary advice in the Great Depression, with equally dismal results.

Lenders and their friends in international agencies inevitably preach deflation; it enhances their assets and incomes, and we ought therefore to take their advice at a discount.

What is really surprising is why so little attention has been paid to the performance of the lenders' economies. It is after all only if we grow, the U.S. and the rest of the West, that Third World nations can earn enough to meet any debt obligations. Then, they can spend what is left of their export earnings to import plant and machinery and spur their own growth.

Unhappily, the U.S. and the other big lenders have, for the most part, suffered sluggish growth in the 1980s—indeed, even in the 1970s—nearer two percent a year instead of a potential growth rate of four. And I find it rather astonishing that, of all countries, it is Britain that is now leading the growth parade in the West, which suggests how far off the track we have gone.

In these circumstances, Third World nations are unlikely to advance, unlikely to earn enough to pay off debt. Unless Brazil, Mexico, Argentina, and the others can sell their television sets, autos, steel, and the rest to expanding Western markets, they have little prospect of paying off their loans. But somehow Western financial authorities rarely stress Western economic responsibilities. No repayment schedules were tied to lenders' performances.

There is an implicit recommendation buried in this. The IMF should stop trying to fix conditions for Third World loans from money centers. To begin with any money now loaned simply enables debtors to meet obligations to banks and shouldn't be confused with aid. Second, the IMF's deflationary tilt makes it a very dubious mentor for borrowers. Its credit, like that of the banks, is extended chiefly for the sake of the banks. Neither, therefore, is entitled to offer advice, good or bad, to the borrowers.

There is no point in assessing blame for the present uncomfortable state of affairs. In the 1970s, the commercial banks, we know, sought out Third World borrowers with an almost indecent eagerness, pushing money on them that had been gathered from Arabs. Third World borrowers sometimes used the funds to build useful things like dams or roads; as often as not, the money financed real estate and hideaways in Paris and Manhattan, exotic weapons for an ambitious military, and flight capital in Zurich, Geneva, and other safe havens. Well, that is the past.

Apart from slow growth, the Third World's ability to repay has been hampered by still another force, the unfortunate and little-noticed destruction of the General Agreement on Tariffs and Trade. The revival of a fearsome web of protectionist devices has amounted to a universal repudiation of one of the most admirable of the postwar instruments. Voluntary export restraints, orderly marketing arrangements, and reckless antidumping actions have surrounded all Western markets and Japan with an array of bristling barriers that make Smoot-Hawley look like a Ricardian interlude. Now, all of us—Japan, the Common Market, and the U.S.—frustrate Third World attempts to industrialize. We all prevent the export earnings that could make a dent in the mountain of debt.

In the early years of the crisis, we could make Latins and others sweat over the consequences of nonpayment. We warned that defaults would deprive them of new money. This has now become a hollow threat, as many of the witnesses have pointed out. There is no new money of any significance.

Imagine how long, after all, Mr. Reed at CitiCorp or the chief executive at Chase Manhattan would last if the shareholders discovered that he had approved fresh loans of any size to a Brazil, a Mexico, or the others. Instead, the banks are dealing off their loans at cut-rate prices to each other, reducing what is called their exposure as rapidly as possible. So, a regional bank can buy some of CitiCorp's Brazilian paper at 70 cents on the dollar. CitiCorp is not likely to lend any more on its own. In sum, the carrot and stick of new loans has withered on the ground.

Although the borrowers are no longer afraid of losing what they can't get, there is still—at least for now—an almost curious will to pay on their part. Some day, I suppose, their loans might resume, and no developing country wants to be left out then. But it is now clear there are limits to what sovereign nations will do to get this money.

Their governments will not impose so austere a regime that they risk being overthrown. There are predictable limits to what governments will do to attain good standing in the club of amiable borrowers, and I claim no insight for having predicted as much in my book, "The Global Struggle for More."

More countries will follow the lead of Brazil, I suspect, which has stopped interest payments. A new kind of bargaining has emerged that reflects an old saw: "If I owe a bank 1,000, I am in trouble; if I owe one million, the bank is in trouble."

All this will surely affect bank profits, a peculiar artifact anyway of rather creative accounting. The sale of assets, the loans, at a fraction of their claimed value will drive profits down; and so, at least initially, will all efforts to tailor interest payments to the capacity of borrowers. But the fiction in reported bank earnings has already been discounted by the stock market. Investors pay about twice as much for each dollar of industrial earnings compared to what they pay for banks.

And this suggests that investors believe roughly half of bank profits are water, imagination. We can, therefore, discuss measures to relieve the crisis without any pretense about profits. They will come down, at least until the crisis is cured. It is tempting to tell the banks who loudly proclaim free and unfettered enterprise that the debt is their problem, to be dealt with as they see fit.

If this means long periods without dividends and without bonuses for Mr. Reed and the other executives, that is only just. Since the 1970s, dividends and bonuses have flowed to a considerable extent from the profitable business in the Third World. But the banks, after all, did not create the conditions that make payment so hard; they did not create the protectionist devices that cripple Third World trade and the fiscal and monetary policies that inhibit and produce sluggish growth. It is equally tempting to tell the banks to write off their loans slowly, over time, erasing the problem perhaps in a generation.

The trouble is that wiping out the Third World loans wipes out the capital of the largest banks in New York and London. It could be replaced, but the big banks are so badly managed that it would cost a lot to do so; and investors would insist on a very high premium indeed.

If the major Latin borrowers all repudiated, the large banks would be extinguished, to be revived only by heroic credit-creating efforts at central banks. And this could be done, but it would endow us with a nationalized banking system in the great money centers, a plausible but less than optimum solution

There probably is a way to save banks from the dubious assets and questionable profits they now count in the Third World—limit debtor payments to a bearable fraction of export earnings, perhaps 20 percent. Twenty percent is the conventional, safe figure for debt service that economists have used for years. There is no magic in it.

In effect, payment would be based on ability to pay. In a world of slow growth, the banks are now extracting nearly 40 percent of the borrowers' sales abroad. And this is unsustainable; they won't stand for that. A 20 percent take would cut profits in half for the banks, but only in the very short run. The banks would now have a vested interest in lending their considerable strength to the good fight for lower trade barriers and the equally noble fight for fuller use of our unused human and plant resources.

The banks would have reason to support more open markets and faster growth. As the world economy expanded and Western markets opened, the 20 percent take would translate into ever-higher absolute amounts. Principal as well as interest might even be collected some day, a possibility that nobody dreams of now. For the Third World, 20 percent is probably a bearable level. (The precise level would be a subject of bargaining.) It would assure debtors they need pay only what they can, that they could keep four-fifths of their exports for development, luxuries, weapons, whatever.

The aim is to create a framework in which borrowers have a realistic prospect of repayment without misery while lenders are enlisted in the crusade against a medieval economics that deprives us of goods and services, deprives us of increases in our standards of living.

Senator BRADLEY. Thank you very much, Mr. Nossiter. Mr. Wells?

[The prepared written statement of Mr. Nossiter follows:]

Testimony of BERNARD D. NOSSITER

Journalist, Author of The Global Struggle for More

Senate Finance Subcommittee on International Debt,

April 6, 1987

It is now clear that the crisis of third world debt is no mere episode to be cured by a restorative dose of austerity taken by borrowers. This was the widely held belief in Western financial circles, central banks and the International Monetary Fund soon after Mexico inaugurated the cycle of quasi-defaults in 1982. The conventional banking wisdom held that if only Mexico, Brazil and the others curbed consumption and budget deficits, devalued currencies and ended subsidies for bread, buses and other goods and services (but never weapons), their economies would magically right themselves, their exports would boom, the heavy burden of debt would vanish. This of course was nonsense. Latin America, for example, has endured a 10 percent fall in per capita income since the Mexican fall from grace; investment has dropped by one-third; unemployment in some countries has climbed above 50 percent. They do not feel better for austerity. The financial authorities, it should be recalled, offered similar deflationary advice in the Great Depression with equally dismal results. Lenders and their friends in international agencies inevitably preach deflation. It enhances their assets and income.

What is really surprising is why so little attention has been paid to the performance of the lenders' economies. It is only if they grow that third world nations can earn enough to meet debt obligations. Then, they can spend what is left of their export earnings to buy imported plant and machinery and spur their own growth. Unhappily, the U.S. and other big lenders have, for the most part, suffered sluggish growth in the 1980s, about two percent a year instead of four. In these circumstances, third world nations are unlikely to advances, unlikely to earn enough to pay off debt. Unless Brazil, Mexico, Argentina, Venezuela and the others can sell their television sets, autos, steel and the rest to expanding Western markets, they have little prospect of paying off their loans. But somehow Western financial authorities rarely stressed Western economic responsibilities and no repayment schedules were tied to lenders' performances.

There is an implicit recommendation buried in this: the IMF should stop fixing conditions for third world loans from money centers. The money is now loaned simply to enable debtors to meet obligations to banks and should not be confused with aid. Anyway, the IMF's deflationary tilt makes it a dubious mentor for borrowers. Its credit, like that of the banks, is extended chiefly for the sake of the banks. Neither, therefore, is entitled to offer advice, good or bad, to the borrowers.

There is no point in assessing blame for the present uncomfortable state of affairs. In the 70s, the commercial banks sought out third world borrowers with an almost indecent eagerness, pushing money on them that had been gathered from Arabs. Third world borrowers sometimes used funds x to build useful things like dams or roads; more often than not, the money financed real estate and hideaways in Paris and Manhattan, exotic weapons for an ambitious military and flight capital in Zurich, Geneva and other safe havens.

Apart from slow growth, the third world's ability to repay has been hampered by still another force, the destruction of the General Agreement on Tariffs and Trade. The revival of a fearsome web of protectionist device has ~~[illegible]~~ amounted to a universal repudiation of an admirable postwar instrument. Voluntary Export Restraints, Orderly Marketing Arrangements and reckless anti-dumping actions have surrounded all Western markets and Japan with an array of bristling barriers that make Smoot-Hawley look like a Ricardian interlude. Now all of us, Japan, the Common Market and the U.S. frustrate third world attempts to industrialize. We all prevent the export earnings that could make a dent in the mountain of debt.

In the early years of the crisis, we could make Latins and others sweat over the consequences of non-payment. We warned that defaults would deprive them of new money. This has now become a hollow threat. There is no new money of any significance. Imagine how long the chief executive of Citicicorp or Chase Manhattan would last if share holders found he had approved fresh loans of any size to Brazil, Mexico or the others. Instead, the banks are dealing off their loans at cutrate prices to others, reducing what is called their exposure as rapidly as possible. A regional bank may buy some of Citicorp's Brazilian paper at 70 cents on the dollar; it is not likely to lend on its own. In sum, the carrot and stick of new loans has withered on the ground.

Although the borrowers are no longer afraid of losing what they can't get, there is still, at least for now, a will to pay. Some day loans might resume and no developing country wants to be left out. But it is now clear that there are limits to what sovereign nations will do to get this money. Their governments will not impose so austere a regime that they risk being overthrown. There are predictable limits to what governments will do to retain good standing in the club of amiable borrowers. I claim no insight for having predicted as much in my book, The Global Struggle for More. More countries will follow the lead of Brazil which has stopped interest payments. A new kind of bargaining has emerged that reflects an old saw: If I owe a bank 1000, I'm in trouble; If I owe 1 million, the bank is in trouble.

All this will surely affect bank profits, a peculiar artifact of creative accounting. The sale of assets, the loans, at a fraction of their claimed value, will drive profits down. So, at least initially, will all efforts to tailor interest payments to the capacity of borrowers. But the fiction in reported bank earnings has already been discounted by the stock market. Investors pay about twice as much for each dollar of industrial earnings compared to what they pay for banks. This suggests that investors believe about half of bank profits are water. We can therefore discuss measures to relieve the crisis without any pretense about profits; they will come down, at least until the crisis is cured.

It is tempting to tell the banks who loudly proclaim free and unfettered enterprise that the debt is their problem to be dealt with as they see fit. If this means long periods without dividends, without bonuses for executives, ~~where~~ that is only just. Since the 1970s, dividends and bonuses have flowed to a considerable extent from the profitable business in the third world. But the banks, after all, did not create the conditions that make payment so hard, the protectionist devices that cripple third world trade and the fiscal and monetary policies that yield sluggish growth.

It is equally tempting to tell the banks to write off their loans slowly, over time, erasing the problem in a generation. That trouble is that wiping out the third world loans wipes out the capital of the largest banks in New York and London. It could be replaced, but the big banks have so badl naged, it would COST a lot to do so. Inve~~x~~stors would insist on a very high premium indeed. If the major Latin borrowers all repudiated, the large banks would be extinguished, to be revived only by heroic credit-creating efforts~~a~~ at central banks. This would endow us with a nationalized banking system in the great money centers, a plausible but less than optimum solution.

There probably is a way to save banks from the dubious assets and questionable profits they now count in the third world. Limit debtor payments to a bearable fraction of export earnings, perhaps 20 percent. In effect, payment would be based on ability to pay. In a world of slow growth, the banks are now extracting nearly 40 percent of the borrowers' sales abroad. This is unsustainable. A 20 percent take would cut profits in half, but only in the very short run. The banks would now have a vested interest in lending their considerable strength to the good fight for lower trade barriers and the equally noble fight for fuller use of our unused human and plant resources. The banks would have reason to support more open markets and faster growth. As the world economy expanded and Western markets opened, the 20 percent take would translate into ever higher absolute amounts. Principal as well as interest might even be collected some day. For the third world, 20 percent is probably a bearable level (the precise ratio would be a subject of bargaining); it would assure debtors they need pay only what they can, that they could keep four fifths of their exports for development, luxuries, guns, whatever. The aim is to create a framework in which borrowers have a realistic prospect of repayment without misery while lenders are enlisted in the crusade against a medieval economics that [illegible] deprives us of goods and services, increases in our living standards.

END

STATEMENT OF JOEL WELLS, JR., PRESIDENT, SUNTRUST BANKS, INC., ATLANTA, GA

Mr. WELLS. Thank you, Mr. Chairman, and I certainly appreciate your having invited me to be here today to join the panel in discussing this important issue. I have submitted a prepared statement and, in the interest of time, I won't repeat everything in the prepared statement.

Senator BRADLEY. Your statement will be placed in the record in full.

Mr. WELLS. I would like to observe at the outset that I think progress has been made on one important front. Mr. Chairman, I don't think you are in danger today of being described again as being incredibly naive by having raised the issue of the potentiality of debt relief. Events, as have been described today, are certainly moving in the direction that we need to consider new approaches.

And I don't subscribe to the belief that talking about the possibility of interest relief or debt forgiveness or mechanisms for debt equity swaps are likely to further impair either the developing countries or the creditor banks.

And I think new ideas, including several now being aired both in the Senate and the House, are deserving of consideration, including the prospect of a new multilateral organization that Senator Sarbanes described.

In your invitation to testify, we were asked to comment, among other things, on principles for managing Third World debt that would restore confidence both in debtor countries and creditor banks.

And since I am a representative of the banking industry, I thought perhaps I might make a few observations about the perspective that I see from the point of view of a banker.

Mr. Chairman, the biggest difficulty I think today that U.S. creditor banks have in dealing with the problem is that as serious as it is, it is not the only problem our banks face. Over the last 20 years, we have been in the process in this country of dismantling carefully thought-out banking structure which was put in place 60 years ago. This process has popularly become known as "banking deregulation."

Unfortunately, it has been a haphazard process. It has not been fully planned; it has been expedient; and it is today incomplete. And the result is that today the business of banking in this country has been cast into the greatest period of uncertainty which we have faced in 60 years.

About two weeks ago, the Federal Deposit Insurance Corporation announced that the profitability of all insured banks in our country declined year to year, last year, for the first time in 25 years. And 20 percent of all insured banks operated at a loss. Mr. Nossiter commented on the discount that the money center banks today sell at, and I checked that again myself in preparing for this testimony.

Salomon Brothers keeps a moving index of multiples, and last Monday—which is the latest available date—the money center bank index was selling at 42 percent of the S&P 500, which is the lowest level since they have begun keeping the numbers, going all the way back to 1960.

However, bank stocks of profitable banks and banks that have less exposure to the less developed country debt situation, like my own company, are also selling at tremendous discounts. So, in this environment, I don't think it is any wonder that we have seen extraordinary steps taken to support bank profitability, including the actions of restructuring international debt to try to keep loans performing at market rates. Last year, this country saw a legislative miracle. We saw a new Internal Revenue Code adopted which represented the most comprehensive, radical overhaul of the Federal Income Tax system in our lifetime.

And since I have the opportunity this morning of appearing before one of the chief miracle workers, the essence of my statement is: We need another miracle. To accomplish what was accomplished in tax reform, the most formidable task was in overcoming the commonly held belief that what was needed to be done couldn't be done. There was a mindset that real reform was impossible. We face a very similar situation in the international debt area.

The problem is that the international debt Situation, as critical as it is, is not the issue. It is an issue. The issue is the structure of banking in the United States and its relationship to the worldwide financial markets which are now a reality of life. I believe we all know that.

I believe we also know that a meaningful, comprehensive overhaul of our banking laws is long over-due. However, like tax reform, there is a mindset that a plan really to deal with the issues is not politically feasible.

For the past 20 years, we have been dealing with the structure of banking in our country much like we dealt with the problem of tax reform. There have been calls for real reform and a thoughtful, comprehensive plan of change; but what has occurred has been expediency after expediency and loopholes compounded by loopholes, climaxed by our now having that contemporary phenomenon now called the "non-bank bank."

I might observe that at least we never got so far afield in taxation as to have the "non-tax tax." Efforts to grapple with the real problems in banking and the financial markets have bogged down, like the tax issues, into interminable siege warfare of special interests. The international debt problem is a critical problem. However, it is not the only problem and, indeed, it is inexorably linked to the other issues which involve what is the business of banking going to be, to what degree is it going to be regulated, and who is going to be permitted to own banks?

There are limits to what the U.S. Congress can or should do in facilitating a direct solution to the international debt problem. Obviously, Congress should not mandate that the creditor banks extend debt relief unless Congress is prepared to purchase the debt. On the other hand, Congress is clearly charged with the responsibility of defining the structure of banking, and Congress should do that, whether there was a debt problem or not.

What I am suggesting, however, is: If Congress will deal with the issues of banking structure and will do so in the same comprehensive, straight-forward fashion with which tax reform was dealt, that solution will do as much as anything I know to improve the ability of the U.S. creditor banks to deal with the debt problem.

Just 10 days ago, the United States Senate passed a bill providing for the appointment by a president of a national commission on "Competitiveness in the Financial Services Industry." Whether we need another commission or not, we certainly need a new commitment, not just from Congress but also from the executive branch of government to make our financial services industry competitive.

To accomplish this, we need for banking to have the same priority over the next two years that tax reform had for the past two years. And Mr. Chairman, to accomplish what we need to accomplish, we need to approach it with the attitude you described in your remarks upon receiving the Wilson Award at Princeton University. We need to decide what the public interest requires rather than what the special interests want.

Last week I had the opportunity to make a talk in Nashville, and I thought it was appropriate to speak in Nashville about banking issues because that is the home of Andrew Jackson, who had a considerable interest in banking. In preparing for that, I learned from research that Andrew Jackson once said: "Ever since the South Sea Bubble collapsed, I have been afraid of banks."

And because of Jackson's concern, as I am sure you know, banking was the principal issue in the presidential election of 1832. I hope banking doesn't become the principal issue of the presidential election of 1988 because of concerns like those Jackson had, and I hope we don't let that happen.

Thank you.

Senator **Bradley**. Mr. Wells, let me thank you for your testimony.

[The prepared written statement of Mr. Wells follows:]

Statement of
Joel R. Wells, Jr.
before
Subcommittee on International Debt
Committee on Finance
United States Senate
Washington, D.C.
April 6, 1987

Mr. Chairman and members of the Subcommittee, I am Joel R. Wells, Jr. I am President of SunTrust Banks, Inc., a bank holding company headquartered in Atlanta, Georgia. Through three subsidiaries, Sun Banks, Inc., Trust Company of Georgia, and Third National Corporation, we own and operate 52 banks in Florida, Georgia and Tennessee. As of December 31, 1986, we were the 18th largest United States bank holding company, in terms of asset size.

The debt burden of the developing countries is a very critical problem for the debtor countries, for the creditor banks and for the industrial countries who desire to export new goods and services to the debtors. Last year's report of the Inter American Development Bank stating that 1985 imports of the Latin American region actually fell to a lower level than 1974 dramatically underscores the critical character of the problem.

For the past four and one-half years, we have succeeded in avoiding outright default of debt. Whether we have improved the basic situation is subject to debate. While we have the highest regard for wise counselors who urge that we stay the course we have been following, there is a growing consensus that new approaches are needed.

There is no doubt that the goal should be to reward reform rather than force crisis.

It is becoming daily more apparent that, in several situations, significant long-term debt relief may be required.

Resistance to lending new money to service existing debt is increasing.

There is a growing desire for exit mechanisms for banks who desire to terminate their participations.

On the other hand, overall, the creditor banks have been dealing with the problem in a reasonable fashion, given the difficulties and environmental circumstances. From the standpoint of the borrower, the terms of the recent Mexican restructuring, and the proposed terms of the Philippine restructuring, indicate that the banks are prepared to be innovative, and flexible, in granting terms.

Whether even better terms will be required, including the potentiality of actual debt forgiveness, is a question of judgment. Whether it is prudent to speculate about this possibility is also an issue upon which reasonable people can disagree.

I do not personally think we are doing a disservice to the process to have open discussions of the problem. I think hearings such as those being held by this Subcommittee are useful and constructive.

I do not subscribe to the belief that talking about the possibility of interest relief, or debt forgiveness, or mechanisms for debt-equity swaps, is likely to further impair indebted developing countries or creditor banks. I think new ideas, including several now being aired both in the Senate and the House are deserving of consideration.

One of the issues that has been debated is that of lending new money to provide funds for debt service versus other methods of providing cash flow relief. Our company has been among those which have been extremely reluctant to lend new money. However, at this point I think it is more constructive to spend time discussing what we need to do rather than what we should have done.

I certainly don't want to imply this morning that across-the-board debt relief is going to be required. I think that's an unfair, and dangerous, generalization. On the other hand, if debt relief is required in specific situations, I would like to talk about the environment and circumstances which I think will facilitate the extension of debt relief.

There are certain considerations in this problem that transcend the direct interests both of the indebted industrial countries and their creditor banks.

There are public sector considerations to the industrial countries, including in the case of the United States, both economic and national security interests. I believe these considerations justify encouraging more multilateral organization involvement, including the possibility of new entities to facilitate debt discount and debt equity swaps.

With regard to the indebted developing countries, the key to new flows of credit is the providing of assurances that the old debt is going to be dealt with one way or another. While an analogy with reorganized private enterprises is somewhat simplistic, we do know from experience that private companies emerging from well planned reorganization usually are seen as better credit risks.

Insofar as the creditor banks are concerned, the market appears already to have significantly discounted the possibility of material changes in the status of developing countries' debt. Salomon Brothers maintains a continuing index of price earnings ratios of U. S. money center banks. As of March 30, 1987, the money center price earnings multiple relative to the Standard and Poor's 500 price earnings multiple is 42.2 percent. This is the lowest percentage of this multiple relative to the S&P 500 multiple going all the way back to 1960.

In the invitation to testify, we were asked to comment, among other things, on principles for managing third world debt that would restore confidence both in debtor economies and creditor banks.

The biggest difficulty our U. S. creditor banks have in dealing with this problem is that, as serious as it is, it is not the only problem our banks face.

Over the last twenty years, we have been in the process in this country of dismantling the carefully thought out banking structure which was put in place 60 years ago. The process has popularly become known as "banking deregulation." Unfortunately, this process has been haphazard, it has been poorly planned, it has been expedient, and it is today, incomplete. The result is that today the business of banking in this country has been cast into the greatest period of uncertainty which we have faced in 60 years.

In 1986, according to a recent release by the Federal Deposit Insurance Corporation, profitability of all insured banks declined year to year for the first time in 25 years, and 20 percent of all insured banks operated at a loss. Even stocks of profitable companies, like my own, sell at a huge discount to the average multiple of the S&P 500. In this environment, it is little wonder that extraordinary steps are taken to support bank profitability, including restructuring international debt to try to keep loans performing at market rates.

Last year a legislative miracle occurred: A new internal revenue code was adopted which represented the most comprehensive, radical overhaul of the federal income tax system in our lifetime.

Since I have the opportunity this morning of appearing before some of the chief miracle workers--members of the Finance Committee of the U. S. Senate--the essence of my statement is "We Need Another Miracle."

To accomplish what was accomplished in tax reform, the most formidable task was in overcoming the commonly held belief that what was needed to be done, couldn't be done. There was a mind set that real reform was impossible.

We face a very similar situation in the international debt area. The problem is that the international debt situation, as critical as it is, is not the issue. It is an issue. The issue is the structure of banking in the United States and its relationship to the world-wide financial markets, which are now a reality of life.

I believe we all know that. I believe we also know that a meaningful, comprehensive overhaul of our banking laws is long overdue. However, like tax reform, there is a mind set that a plan really to deal with the issues is not politically feasible.

For the past 20 years, we have been dealing with the structure of banking in our country much like we dealt with the problem of tax reform. While there have been calls for real reform and a thoughtful, comprehensive plan of change, what has occurred has been expediency after expediency, and loopholes compounded by loopholes, climaxed by our now having that contemporary phenomenom called the "non-bank bank." At least we never got so far afield in taxation as to have the "non-tax tax."

Efforts to grapple with the real problems in banking, and the financial markets, have bogged down, like the tax issues, into interminable siege warfare of special interests.

The international debt crisis is a critical problem. However, it is not the only problem, and indeed it is inexorably linked to the other issues which involve what is the business of banking going to be, to what degree is it going to be regulated, and who is going to be permitted to own banks.

There are limits to what the U. S. Congress can do or should do in facilitating a direct solution to the international debt problem. Obviously, Congress should not overtly mandate that the creditor banks extend debt relief unless Congress is prepared to purchase the debt.

On the other hand, Congress is clearly charged with the responsibility of defining the structure of banking and Congress should do that whether there was a debt problem or not. What I am suggesting, however, is, if Congress will deal with the issues of banking structure, and will do so in the same comprehensive, straightforward fashion with which tax reform was dealt, that solution will do as much as anything I know to improve the ability of the U. S. creditor banks to deal with the debt problem.

Ten days ago, the United States Senate passed a bill providing for the appointment by the President of a National Commission on Competitiveness in the Financial Services Industry.

Whether we need another commission or not, we certainly need a new commitment, not just from Congress, but also from the executive branch of government, to make our financial services industry competitive.

To accomplish this, we need for banking to have the same priority, over the next two years, that tax reform had for the past two years. And, Mr. Chairman, to accomplish what we need to accomplish, we need to approach it with the attitude you described in your remarks upon receiving the Wilson Award at Princeton University: We need to decide what the public interest requires, rather than what the special interests want.

I recently gave a talk on banking in Nashville, and I said it was appropriate to talk about banking in Nashville because that was the home of Andrew Jackson who had considerable interest in banking. Jackson once said, "Ever since the South Sea Bubble collapsed, I have been afraid of banks." And because of Jackson's concern, banking was the principal issue in the presidential election of 1832. I hope banking doesn't become the principal issue of the presidential election of 1988 because of concerns like those that Jackson had. Let's not let that happen.

Senator **Bradley**. Let me say to the entire panel that I felt that all of your testimony was absolutely first rate, and I think that members of the Banking Committee and the Foreign Relations Committee should have copies of your testimony. I will make sure that they do get copies of your testimony.

I think that it is important to be very clear, and that is what I liked about your testimony. It was very clear. Mr. Hurlock, from your testimony, it seems clear that you believe—and the numbers would back you up—that banks since about 1981 or 1982 have essentially lent no money, not for working capital or investment in these countries but simply to pay the interest. Is that correct generally?

Mr. **Hurlock**. That is correct. The last new money that I am aware of that was loaned by banks to a country in need was that of Turkey in 1979 when, in fact, we had a new money agreement. It is the last one I am aware of.

Senator **Bradley**. So, all of the new restructuring agreements that we have heard both prior to and subsequent to the announcement of the Baker Plan have really simply been loans of money to a Third World country where it rests as an accounting fact and is then returned to the bank in terms of interest paid on that debt. Is that correct?

Mr. **Hurlock**. That is correct. Very often, the disbursements never went to the country in question, but were returned within the 90 day lapse period from the payment of interest in order to solve back interest defaults.

Senator **Bradley**. Now, you are someone who is not an outsider in this area of bank restructuring. Is that correct?

Mr. **Hurlock**. That is correct.

Senator **Bradley**. Could you list for the committee the various restructurings that you have first-hand knowledge of?

Mr. **Hurlock**. We have been involved with Indonesia, Turkey, Zaire, Gabon, Morocco, Peru, Panama, Honduras, and Costa Rica.

Senator **Bradley**. Now, you have also pointed out that the agreements to loan new money that would be returned to the bank in the form of interest payments was also lent at full market value. Is that correct?

Mr. **Hurlock**. In some cases at rates in excess of the old loans.

Senator **Bradley**. Pardon me?

Mr. **Hurlock**. In some cases, at rates in excess of the old loans because the market perception of the credit value of the country had deteriorated.

Senator **Bradley**. Would you find that when a bank is assessing its interest, have you ever known any consideration to enter the picture other than the consideration of repayment?

Mr. **Hurlock**. I am not aware of any. In fact, in the usual negotiation, one is cited—regulations and other hard to find provisions which require the banks to act in the fashion that they have acted. And it has taken some years for people, I think, to become aware of the simple question, for instance: What would a bank have to write off if it accepted a below market rate? The assumption has been it would have to write off a proportion of its loan. Question: Would it? And if it would, would it have to write off more than the reserves which it is currently carrying?

Senator BRADLEY. That leads to the anomaly then of a loan to the Soviet Union being offered at a lower interest rate than a loan to Mexico or Brazil?

Mr. HURLOCK. That is correct.

Senator BRADLEY. You also pointed out that you believed that the priorities of the various actors in this drama have little to do with each other. Could you once again state what you view the priorities to be of the various actors and how they have little to do with each other?

Mr. HURLOCK. Well, that explanation should begin with the proposition that the commercial lenders are the biggest participants in the plan and that their support is vitally needed as a practical matter. In order to secure that support, the commercial lenders have been able to impose in the negotiating process a requirement on the official lenders to come up with as much money as they possibly can so that the commercial lenders can come up with as little money as is necessary to close the gap. What this has done is to compromise—at least that is my view of it—the position of the IMF and the World Bank in the process. The World Bank has gotten into the business of doing structural adjustment loans; I have always wondered where that authority comes from in the case of a development bank.

The IMF, which as I said in 1946 was conceived as a last-resort lender to solve liquidity crises, and their programs seldom go beyond three years and more often are 12 to 18 months, as a liquidity crisis would indicate; but that is not our problem; and the IMF has been required now to not impose the conditions on the austerity programs for the countries but also to do the bidding of the other participants to the fullest extent possible in order to maintain this figment of full payment of interest.

Senator BRADLEY. The various actors now, the commercial banks, you see it as their objective to maximize their return and to ensure longer term stability and profitability. Is that not correct?

Mr. HURLOCK. The last half of it I don't see as part of their objective at all. It is a very short leash approach to maintain earnings at full levels for the short term, with the hope that within six to twelve months a solution will be found. Very often, when you are negotiating these arrangements, it is the case that the agreements you are about to sign are already in default. It seems a senseless process but that is what goes on, and you can almost—taking a week out in between—do your negotiations seriatim, one after the other, in order to cover that problem.

Senator BRADLEY. So, you would say that the commercial banks' objective is only short-term earning?

Mr. HURLOCK. I am afraid it is so, and it is so because of the financial environment in which they operate and the regulations against which they must publish their earnings.

Senator BRADLEY. And then, the institutions like the IMF—their priority is what?

Mr. HURLOCK. It is very hard to determine what their priority is.

Senator BRADLEY. They have a confused priority?

Mr. HURLOCK. Well, they have a different priority than they had. I don't think the IMF as a last-resort lender for liquidity crises really has much to do any more. The crises have gone beyond that.

They are pointed at as the source of dictating or indicating what the austerity programs will be.

However, those programs used to be somewhat informal in nature, and they were prepared to be flexible. Now, if there is a change, there is cross default to the commercial lending, that is, if there is a change; and even if the IMF agrees to the change, the commercial lending agreement falls into default. So, the roles have become very blurred.

Senator **Bradley**. So that you see emerging the commercial banking sector exerting greater control over the international institutions?

Mr. **Hurlock**. As the biggest player, it is inevitable.

Senator **Bradley**. And you see that as a mismatch?

Mr. **Hurlock**. It certainly cannot be responsive to the requirements of the crisis as it has developed.

Senator **Bradley**. Another actor in this drama is, of course, the Third World country itself. What do you see its priorities to be?

Mr. **Hurlock**. The first thing that has to be said there is there are no developing countries that are essentially similar, one to the other. The point was made graphically in a negotiation on behalf of one of the Latin American countries when the opening remark by the chairman of the steering committee was that he had just come from Poland and he was going to do here just what he had done in Poland, which was a bit mind-boggling as a beginner; but that is how we began.

And the developing countries are each different. Many of them have complied as closely as they could with conventional wisdom and with the IMF program, and they have only been deceived and disappointed to find that even close adherence to those programs in the crisis which has developed has not produced the result.

Senator **Bradley**. And you would reference then, say, Dr. Bailey's testimony in the previous panel on Ecuador, as an example?

Mr. **Hurlock**. That is correct. You would contrast Mexico as a petroleum producer with Costa Rica as a coffee producer. I don't find any similarities between those two countries.

Senator **Bradley**. In the way they have been treated?

Mr. **Hurlock**. That is right.

Senator **Bradley**. What about the actor of the United States Congress? Where do see the priorities?

Mr. **Hurlock**. Well, the United States Congress, if we look at what has happened, has participated in one way or another in supplying or going along with debt relief to many of these countries, the issue that has become sharper as we have gone along is: What are the legal provisions now which affect a bank's treatment of these debts that have become in default? And I think there can be no arguing with the proposition that that is not clear. One can by synical and say that the obscurity has been used, but forgetting that, it isn't clear. And you could go to the FDIC, and they will be pretty clear if you ask them what the situation is, but that has received no publicity; and I think we do need some legislative clarification that makes it very clear that, when you go to a negotiation with a bank and it says this is what we have to do with your debt, that will not be the case.

Senator **Bradley**. So, the Congress' priority is to assure the stability of the banking system and to facilitate a more generous treatment of, say, debt or interest rate relief so as to generate growth and increase jobs in the United States. Is that correct?

Mr. **Hurlock**. I have trouble with normative words like "generous." I believe more reasonable treatment to meet the situation as it exists.

Senator **Bradley**. I take it from your testimony that what you are arguing for with regard to the Third World countries is something along the lines of ability to pay, and I take that to be Mr. Nossiter's explicit viewpoint in his limitation of 20 percent of export earnings.

Mr. **Nossiter**. Exactly so. The number, as I have said, I don't think is terribly important, but the concept of ability is not particularly generous; it is simply bedrock common sense. And I must say, as I have listened to the testimony, I am impressed by the near unanimity of opinion that something must be done, but I am sometimes disturbed by the use of the word "relief" or even "generous treatment," because I don't see this as a break or a gift to the Third World. If anybody is getting relieved here, it is the banks that are being taken off the hook in a way least painful for all of us. It is a hook that they have got us all on.

If there is relief, it is relief for the banks. At some point, if we continue down the present path, I think it is quite clear for Peru and for other cases that the debtors will simply stop paying. They will call it a delay, a postponement; in the modern world, no one is allowed to repudiate; but essentially, they will and then the banks will really be in the soup with their capital——

So, I do hope that people begin to see this as a relief measure essentially for the banks.

Senator **Bradley**. If I could, I would like Mr. Hurlock and then Mr. Wells to comment on the issue that Mr. Hurlock raised, and that is that if below market interest rate—and I assume that market interest rate is different for different countries and different instruments—so I have some difficulty in defining exactly what market interest rate means if a bank will loan to the Soviet Union one-eighth above LIBOR and to the Philippines seven-eighths above LIBOR—but you know, it depends on the bank's assessment of a particular country, as I understand it. Therefore, how do you make the relative judgments as to what is a general market interest rate? But if you don't want to comment on that—if you find that more or less just a parenthetical aside—you said that there were regulatory problems for a bank that wanted to provide a low market interest rate.

Could you explain what are those regulatory problems?

And Mr. Wells, could you also explain what you see as regulatory obstacles to an interest rate relief approach?

Mr. **Hurlock**. On your parenthetical, if one is talking technical market rate, that is a rate created by a market, prior testimony has given, I think, ample proof that the market rate is three and a quarter to three and three-quarters percent on a large part of this debt. What we talk about in restructuring and rescheduling negotiations is the rate which will be quoted on the restructuring, and it is alleged to be a market rate. What it constitutes is a LIBOR base with a margin, which is as large as the current environment will bear.

When dealing with the Soviet Union, the Soviets have more than one place to go for their money; and it is a competitive situation which we saw a lot of in the 1970s and the early 1980s when the Soviets and other Eastern Bloc countries were borrowing at less than one percent margin over LIBOR. So, if that is a competitive situation, the rescheduling is not.

On the question of what are the regulatory areas that are in doubt, they are very simple issues. If the country pays on a due date for interest and principal less than it is supposed to, does all of that go to interest? As a matter of regulatory requirement? Or may some of it go to principal if the country has decided to pay four percent instead of eight and one-eighth?

Senator **Bradley**. The question is: If a country owes eight percent interest and pays four percent, the regulatory question is what happens to the difference that wasn't paid? Is that the question?

Mr. **Hurlock**. It is a slightly different question. If the country has been unable to negotiate in arrangements with its lenders; and it says in the absence of an agreed settlement, here is what I am going to do. I am going to pay four percent interest, and I will pay something on principal. So, it pays this amount, which is X interest plus Y principal. If it is less than the market rate of interest, is the bank in a position where it must credit all the monies to interest and none to principal, so that we aren't working the debt down? Or may it follow the prescription given by the debtor country? It is alleged often that they may not do anything but credit it all to interest.

Second, if that money is paid and it is less than what is due, what requirement is there that the amount of the debt be written off or that a larger reserve be taken by the bank to represent the reduction in servicing of the debt? It is alleged that this will have an immediate effect. I think there is very good reason to read the regulations, even as they stand, to say that this is not a requirement, or in any event, certainly not a requirement which would require an increase in reserves beyond those that exist.

Senator **Bradley**. Mr. Wells?

Mr. **Wells**. Mr. Chairman, I really don't see this as an issue of what the regulators are doing in treating this debt, nor do I really think we are going to ever get to the point that we are going to legislate a different regulatory treatment of this debt than other debt held by banks.

And even if we did, we are dealing with a question as to whether the market would see through that and treat the financial condition of the bank, seeing right through whatever steps we might take. I think the problem is the materiality of this debt to a number of our large banks.

And I might also say that I think we may be moving rapidly through the period of debating whether that relief should be given as to what happens when the debt relief is given? We have seen just announced last week several of our large banks stepping up, putting Brazil and Ecuador on nonaccrual, with announcement of the adverse impact that will have on bank profitability this year.

The concern I have again is the competitiveness of our banks and the steps that reasonably can be taken to get us through this problem. I think we should be shocked in this country that we don't have but one bank holding company in America that has an AAA debt rating today. And there are a lot of foreign banks that do. And our banks compete with the foreign banks. That is what the real problem is.

All of the steps that I think have been taken to try to keep these loans performing up to now were out of a recognition of the material adverse effect it would have on several large banks, but we didn't do anything else; but we may be through that period. And we have got to deal with the real issue, and the real issue—as I tried to state in my testimony—is not just the foreign debt. We can't separate that from the total picture in banking, and Congress has to move forthrightly to deal with all the issues. And a $7.5 million recapitalization of FSLIC is not the real issue, Mr. Chairman.

Senator **Bradley**. I take it you are not fully satisfied with the banking legislation that was passed in the Senate. You don't have to answer that question. [Laughter.]

Mr. Wells, if you had Latin American debt on your books, would you like to write that down at this moment?

Mr. **Wells**. Mr. Chairman, we do have Latin American debt on our books. It simply happens to be a small amount fortunately in proportion to our assets than the money center banks. And no, we would not like to write it down any more than we would like to write any other debt down. We do have an interest, however, in the status of those countries.

Operating in Florida, it is obvious that the Caribbean Basin and Latin America are very important to our market; and even more than writing the debt down from our perspective is seeing the problem solved.

Senator **Bradley**. Would you like to swap the debt that you have to Latin America for another asset?

Mr. **Wells**. Well, we would certainly be willing to consider that, and that may be part of the solution. That is the reason, I think, the idea of a new multilateral organization to facilitate swaps has some merit.

Now, one thing that has been said here today that I would like to maybe correct a little bit. There has been a lot of talk about swapping debt and discounting debt. Actually, the market for doing that today is a very thin market. It really does not offer yet any real prospects for a lot of debt equity swaps. I think a lot of banks are interested, however, in taking a new approach; and something of that kind right now may be very timely. I do think there is a concensus that the time has arrived to consider new approaches.

I don't think we—any of us—believe we are going to see happen over the next five years what has gone on in the last five years. It seems to me that the proposal for the restructuring of the Philippines may be a move in the direction for some new innovations. I think we are going to see a lot more of those.

Senator **Bradley**. One last question in this area. Could you tell me, if you were making a swap, what are the characteristics of the asset that you would want to take in exchange?

Mr. WELLS. I think we would like to see the broadest range of options. I don't know that there is any one characteristic that——

Senator BRADLEY. Let's say financial institutions simply decided to get a pool of investment dollars and offer a bond. I mean, is a government guarantee essential here in your view?

Mr. WELLS. Well, again, we would like to see the broadest range of options. It would be fine to see a government guarantee. Realistically, I don't think what we are going to see is going to involve a lot of government guarantees, and I think we have got to basically look at things that are going to supplement the private sector effort.

Senator BRADLEY. All right. Mr. Hurlock, do you feel a government guarantee is necessary in any kind of swap arrangement?

Mr. HURLOCK. There are two things to be said about swaps. Number one, it has been going on for some time, and there is one bank that, when Brazil was improving so rapidly, swapped its Brazilian debt for—or swapped its Mexican debt for Brazilian debt. They are not sure today that that was the smartest thing they ever did.

In any event, swapping is like playing basketball at your own end of the court.

Senator BRADLEY. Now, I am going to understand this. [Laughter.]

Mr. HURLOCK. It really doesn't have much effect on the borrower. That goes on between lenders. Much of the debt that you are talking about that has been swapped is already government guaranteed—not U.S. Government guaranteed, but it is government guaranteed, either by Brazil or by Mexico or one of the other debtors. So, you are really talking about a guarantee which lifts it out of the position it is in and makes it something better by way of paper.

Senator BRADLEY. So, you are simply saying that the question of government guarantee, because the Latin American country already guarantees it—the question is having a more stable or wealthier government guarantee it, either directly as a U.S. Government guarantee, or indirectly as World Bank guarantee. Is that correct?

Mr. HURLOCK. That is correct. Yes.

Senator BRADLEY. I would like to ask Mr. Nossiter: In your testimony, you talked about the countries limiting repayment to 20 percent of exports, and you said the country should be free to spend whatever they want on weapons, luxuries, and so forth. Is it your view that conditionality should extend not only to economic questions but also to trying to curtail the kind of rampant purchase of unnecessary weaponry?

Mr. NOSSITER. Of course. I would like to curtail unnecessary weaponry at home and abroad. As a matter of fact, I don't think in this lending exercise we have either the right or the economic power to establish conditions.

I think conditionality has been—forgive me, my friends at the IMF—a disaster by and large. When I used to work here, it was said that the IMF was responsible for as many revolutions as Marx and Lenin combined. They are splendid and decent people, but they really don't know that much about Third World growth; and I think we ought to let the Third World countries get on with as best they can or as ill they can, and some will do well and some will do ill.

I think we ought to be terribly modest about suggesting recipes for growth abroad, particularly when we do so badly ourselves all through the West—and when I say 'we' I mean the West generally. We are entitled to be modest about these things. Our interest is in giving them a chance to revive and in preserving our financial structure from collapse. And I should add without the use of my credit as a citizen to bail the banks out; of course, the banks would be delighted if the U.S. would take this debt off their hands with a new U.S. guaranteed bond. That would be splendid. They would even accept the lower rate of interest, although not too much lower, please.

But no, no, we really must resist this, I think. I don't see why my credit as a citizen should be used to make good the bad mistakes of the CitiCorp and Chase Manhattan and the rest. So, I trust that we don't go that route, just as I trust that we don't have the U.S. set up an intermediary international mechanism to take the paper off the hands of the banks and stick it on me.

By the same token, I think we ought to be quite careful about the conditions we impose; in fact, we probably should not impose conditions.

Senator BRADLEY. So, in your view, how do we get the loan off the bank book and the benefit to the Third World country if we have no taxpayer participation?

Mr. NOSSITER. No conditions.

Senator BRADLEY. No conditionality. How do we do it?

Mr. NOSSITER. A perfectly reasonable question. I can only reply with an almost benign answer. In a world of growing Western economies, it is almost inevitable that Third World economies—no matter how mismanaged, how brutalized—will grow, too. And growth in the West as led by the United States is probably our best hope.

Senator BRADLEY. So, you are saying don't do anything to help these Third World countries grow again other than get your own economy growing again. This your lenders' performance criteria?

Mr. NOSSITER. That is lenders' performance indeed. That is step one. Step two is use these mechanisms that have been used to beat on the Third World up until now—I mean, Mr. Volcker, Mr. Baker, the IMF, and the World Bank—use those mechanisms to beat on my banking friends to see that their interest lies in rearranging the debt, fooling the regulators with an ability to pay interest and principal payment to a portion—some fraction—of export earnings.

Senator BRADLEY. And you intimate in your testimony that that would then put the considerable lobbying power of the financial sector against protectionist legislation?

Mr. NOSSITER. I think it would. They would have such an enormous interest. Their profits would depend very directly on the exportability of these countries which, in turn, would mean on the openness of markets here and in Japan, in the Common Market, everywhere in the West. This is where the Third World must sell.

Senator BRADLEY. Mr. Hurlock, is there any difference in the cash flow of a bank—and Mr. Wells, this will be for you, too—is there any difference in the cash flow of a bank offering interest relief or a bank offering the equivalent of bridge loans?

Mr. **Hurlock**. I don't think there is any difference except that. If the bridge loans are used to pay, let's say, defaulted interest, they will then continue to accrue that interest as earnings and, in addition, they will earn the interest on the bridge loan. The opposite approach is taken, and one simply says we are not going to borrow more money; that eliminates the incremental interest on the bridge loan.

And if one says now we are not going to pay the market rate or the contract rate of interest from the old loan, that will reduce the earnings and cash flow to the bank from the old loans.

Senator **Bradley**. Mr. Wells, do you basically agree?

Mr. **Wells**. I generally agree. I might add that we have not been a supporter of this type of lending.

Senator **Bradley**. Right. You are not a bridge loaner?

Mr. **Wells**. No, sir.

Senator **Bradley**. You just concentrate on roads and [Laughter.] Really, you are entitled to one of those a hearing. Let me ask you, Mr. Hurlock, what is the difference in the recorded profits of a bank offering interest relief and a bank offering bridge loans? First cash flow, now profits?

Mr. **Hurlock**. A significant difference, which has been, I think, quantified by the banks who recently started accruing their Brazilian debt. And it will make a difference to their earnings. The question is: Is there any other way? And isn't that the truth in any event? So, there is a significant difference. There is something of a process going on which I don't think very much has been said about; and that is the contrast between American and European banks.

European banks have something called hidden reserves, which is something we are not supposed to say very much about in this country because it is not acceptable. On the other hand, the fact of the matter is that the European banks, who have large exposures abroad, have handled their problems much better than we have. And one of the reasons is they have significant reserves; they have been in favor of using those reserves to eliminate portions of that debt now. They have been opposed in this exercise by the American banks.

I think that is regrettable. The American banks, because of our system, are forced today—it seems to me—to beg for time, and the time they need is to create over a period of years sufficient reserves so at a time of their choosing, and not of the borrower's choosing, they can write that debt off without, in the meantime, having affected their earnings.

Senator **Bradley**. You think that is their objective?

Mr. **Hurlock**. I think that is their objective. If it were I who were the banker, it would be my objective.

Senator **Bradley**. And you think that runs counter to public policy objectives?

Mr. **Hurlock**. I don't know for sure what the public policy objective is, except if you believe that the quantum of international debt may threaten our banking system and our economy, it has to be contrary to our public policy. Yes.

Senator **Bradley**. Does the smaller negligible difference in bank cash and loan quality justify the difference in profits?

Mr. **Hurlock**. I don't believe so. No.

Senator **Bradley**. No? Let me thank all three of you very much for your testimony. It has been extremely helpful. I think you have shed much light on this subject, and I think that the record of the hearing will be valuable to not only the members of this committee but to the wider Senate as well.

Thank you very much.

[Whereupon, at 12:13 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

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Statement
to the
Subcommittee on International Debt
of the

Senate Finance Committee

by

Robert W. Chandler, Jr.
Advisory Board

on behalf of the

Association of American Chambers
of Commerce in Latin America

April 6, 1987

This statement is submitted on behalf of the Association of American Chambers of Commerce in Latin America to further develop several of the Latin American debt problem issues outlined by John Plunket, AACCLA Past President, in his testimony to the Senate Subcommittee on International Debt, March 9, 1987.

AACCLA's membership in encouraged by the initiative taken by both the executive and legislative arms of the U.S. Government to ameliorate the negative economic, social and political impacts the LDC debt problems have stimulated in most Latin American countries and the Latin American marketplace, generally. While we believe strongly in market differentiation, U.S. driven considerations and improvements which may be applied generically to the region's problems should provide "wholesale" efficiency in terms of U.S.-based financial institutions and corporate investors while providing stimulus-by-example to respective Latin host country debtors.

We hereunder address three areas of concern:

1. Market Versus Mandate Incentives
2. Contemporary LDC Debt Mythology
3. Specific Sectoral Support Incentives

Market Versus Mandate Incentives

Current LDC rhetoric is loaded with jargon ranging in degree of negativity from outright loss of capital to indeterminent suspension of interest of dividend payments. Furthermore, payment has been subject to semantic and real devaluation as to parity, remittability and, worse, in-kind or barter terms.

Thus far, only President Garcia of Peru has said in October 1985, "We default" but, even then, in a diplomatic rather than legal forum, and not totally and irrevocably but temporarily and partially.

The rescheduling process and reporting media accompaniment seemingly have lost sight of the motivating factor behind the previously successful growth patterns in the region which were and continue to be profits based on comparative and competitive economic advantages. AACCLA believes that profits are the key element that lubricates the various dynamic components of industry, commerce and finance that constitute the economic machinery of both our host countries as well as the broader global economy. Since 1982 the profit element has been minimized or eliminated in varying degrees in many economic sectors in most of our host countries. We believe that a renewed awareness of profits as a legitimate and proven motor of growth and innovation must be introduced into the continuing dialogue between the respective government, lender, investor and obligor constituencies of the LDC problem countries. Simply stated, the risk/reward ratios in too many of these markets is not sufficiently competitive with other country and business options in the global market.

We urge this not in the parochial interest of profits per se, but from the conviction that job creation and enhancement, expanded tax bases rather than rates, growth and international commerce are the simultaneous and broadly beneficial consequences of profitable environments and operations.

The adherence to current loss-avoidance positions will at best prolong the status-quo, which we believe is recognized by all concerned to be undesirable. However, we also believe that mandated losses, particularly if charged unrealistically to any one sector, would provoke regressive and recessionary consequences to the region's development.

Thus, we recommend that support of financial improvement in this economically beleaguered scenario be couched in terms of positive incentives rather than coercive or punitive dis-incentives. Even in the framework of positive incentives, sufficient uncertainty and ambiguity persist whereby even postive incentives may prove to be mis-incentives over time.

Contemporary LDC Debt Mythology

As residents and having dealt extensively in the hemisphere over several decades, our local perspective is somewhat at odds with much of the U.S. press and television focus on hemispheric relations and the debt issue, in particular.

Myth #1 - Latin American countries lack resources.

This is simply not accurate since most countries in the region have a wealth of natural and human resources. Furthermore, citizens who continue to do business and reside in these countries control significant financial resources invested in the global capital marketplace. Ironically, two of today's most successful economies, Hong Kong and Taiwan, are founded on resource bases that highlight what poor can mean. The latter, however, have more than compensated for a poor resource base via exemplary economic policies and performance. In this regard, Latin America must respond to the challenge to change inadequate or inappropriate economic policies that have proven to serve their populaces poorly.

Myth #2 - None of the debt will ever be repaid.

This argument encompasses the extreme polarity that characterizes several populist attitudes expressed both in the U.S. and host country debtors. It is, at best, simplistic and, at worst, insulting to countries such as Colombia which has continuously met its external obligations as agreed and contracted. The complexity of the LDC issue absolutely defies all attempts at a quick definition much less a quick fix. While time is of the essence in pursuing innovative methods of facilitating improved financial and commercial flows in the region, AACCLA suggests that the efforts involved will be long term rather than immediate, and that the focus taken be prioritized and country-specific rather than broad brush in terms of issues and geography.

Myth #3 - The LDC debt issue has united Latin America into a cartel.

While certainly a theme of mutual concern, it is highly unlikely that a five year old economic issue will transcend, much less homogenize, so many diverse cultural traditions that for the most part pre-date our own. AACCLA believes that each country is likely to conduct itself in the same spirit of independence and national identity which has characterized its traditional financial, commercial and diplomatic standing in the international community. We further believe that individual, reciprocal attention is due these countries in turn.

Myth #4 - The LDC debt problem belongs to the U.S. money-market banks.

U.S. banks hold less than 40 percent of the region's outstanding debt. With 60 percent of the debt owed to Canadian, European, Arab and Japanese banks, the problem is truly global in scope. Furthermore, as you have heard, the impact on commerce and export industries is equally dramatic and potentially longer lived in terms of lost markets and jobs.

A former planning minister in one of the larger LDC's with refreshing candor has referred to their most recent problem as "an economic crisis entirely created at home with national know-how".

Specific Sectoral Support Incentives

AACCLA contends that much of the professional, technical and institutional infrastructure for managing the LDC debt issue is in place and functional. We do suggest some possible changes in methodology, accounting, and, perhaps, style to engender more pro-active urgency on several fronts.

First we re-affirm our support of the International Monetary Fund and World Bank and urge the support of the U.S. Government on both increased capital resource as well as administrative talent commitments.

Because the lending programs of the IDB are an extremely important element in the mobilization of foreign exchange resources for the economic and social development of Latin America and the Caribbean, AACCLA is in favor of authorization and full appropriation of U.S. contributions to the increases in capital and special fund resources of the IDB. AACCLA also encourages increased IDB financing for private business ventures, and lending to development finance companies.

AACCLA strongly supports the Export-Import Bank and urges that the Bank receive full and adequate support from the U.S. Government to remain strong, financially sound and competitive. The Eximbank is a vital source of supplementary financing for U.S. exporters in competition with other exporting countries.

AACCLA supports the insurance and finance operations of OPIC to facilitate productive investments by U.S. companies in the countries of Latin America as well as throughout the world. We urge consideration by OPIC of an active role in the nascent debt/equity developments in several Latin countries, specifically Mexico and Chile.

AACCLA submits that, beyond free and reciprocal trade agreements, substantial arguments can be made for preferential access to U.S. markets selectively and within a medium term horizon by LDC debtors.

We specifically recommend that Items 806.30 and 807.00 of the U.S. Tariff Schedules be retained, first to preserve, and indeed increase U.S. jobs, and second to obtain mutual economic benefits to the United States and host countries involved in the transformation of qualifying products. We also support the CB initiative and incorporation of 936 benefits in its behalf.

Finally, we address the role of the U.S. banks, because, to paraphrase Willy Sutton somewhat out of context, "That's where the money was". We believe that relief from the drag of under-performing LDC assets is critical to their ability to provide continued financial support to the area and that important new lending must be prompted by adequate pricing and credit quality.

In the former area of "old money", tax adjustment similar to domestic municipal bond conditions would provide banks with enhanced returns for either further rate reductions to borrowers or asset reserve funding.

Similarly tax incentives on new or renewed trade lines would provide additional incentive to finance U.S. exports. In this case, the round-trip effect of increased corporate and payroll taxes at the originating exporter level would largely offset forgone financial income taxes. AACCLA argues that it is counter productive and inconsistent to expect industry, commerce and trade to be conducted in the absence of the banks who will be even less apparent on the Latin American scene without profit incentives.

As pointed out previously, significant regional wealth has been reinvested abroad and much of it in the U.S. For some reason, when capital flows in an East/West direction, it is acknowledged to be consistent with a diversified global investment strategy; whereas, if it happens to take a North/South pattern, it is simply fleeing - presumably from an horrific destiny rather than toward an incrementally beneficial option. Should these deposits, much of which are in port-of-entry rather than money market banks, be relieved of reserve requirements, the incremental funding profits derived could be dedicated to enhanced country lending activities or debt reserves. This concession by the Federal Reserve would be a constructive re-affirmation of its role as an important component of LDC debt management.

In a more innovative vein, we are witnessing the evolution of nascent investment development programs in Chile, Mexico, Ecuador and other venues under the label of debt/equity swaps. Thus far, U.S. banks have acted almost exclusively as intermediaries rather than direct participants in this activity while Eurpoean banks have been actively engaged for their own accounts. We are hesitant to delve into the arcane elements of U.S. bank regulations and accounting, but the consensus of our U.S. bank membership is that they do not enjoy a "level playing field" vis-a-vis banks from other developed countries. Specific handicaps seem to lie in Regulation K provisions and market-to-market valuation requirements under both general and regulatory accounting procedures which predate the evolution of this then-unknown type of activity. AACCLA believes that it behooves both our host countries and our corporate and banking membership to be in the forefront of events that promote a revived investment interest and commitment to Latin America. We believe this is the most encouraging financial development to emerge since 1982 and recommend it for the sub-committee's priority attention.

Thank you.

David D. Hale
Kemper Financial Services, Inc.

One of the most encouraging developments on the international financial scene today is the growing investor interest in third world equity markets. In recent months, Wall Street and the City of London have successfully launched a number of new specialty mutual funds targeted at the equity markets of Korea, Taiwan, India and Thailand. Two U.S investment management firms also have recently launched mutual funds for investment in a diversified portfolio of developing country equity markets while plans are afoot to launch a Brazil fund later this year. The total capitalization of these mutual funds is still modest compared to the huge volume of bank loans which were flowing to the developing countries during the 1970's, but the successful floatation of such funds does represent a potentially important breakthrough in the development of new forms of intermediation for financing third world economic development.

Why the sudden upsurge of interest in developing country equity markets? There are three factors at work. First, financial markets are becoming increasingly integrated on a global basis, so there has been a broad based movement towards international portfolio diversification by the financial institutions of all the major industrial nations in recent years. Secondly, the primary channel for international capital movements today is securities purchases (bonds and equities) rather than commercial bank lending. As Table One illustrates, bonds accounted for nearly $232 billion of international lending activity during the first nine months of 1986 (at annual rates) compared to only $32 billion in 1977. Total international bank lending, by contrast, was only about $66 billion last year compared to $34 billion in 1977 and a peak of $146 billion in 1981. Thirdly, the equity markets of many developing countries have significantly out-performed the equity markets of most industrial countries during the past decade.

This superior performance reflects the benign effects of rapid economic growth on company profits as well as the development of more sophisticated forms of financial intermediation within the developing countries themselves. While there are frequently more political uncertainties associated with investment in the developing countries, many fund managers believe the potential returns will compensate for those risks, especially in the case of East Asia's newly emerging markets. In fact, Japan's extraordinary stock market performance during the 1960's and 1970's is a model for what many fund managers now hope to achieve in Korea or Taiwan. The Tokyo Dow Jones Index crossed the U.S. Dow Jones Index at 1000 in the mid-1960's and now exceeds 20,000. Obviously, the deterioration occurring in the world trade environment will make it difficult for newly industrializing countries such as Korea to duplicate Japan's remarkable success, but even a performance half as good as Japan's would still generate extremely attractive returns.

Historical Perspective

Many pundits regard today's movement towards securitized lending and investment in the developing countries as a uniquely modern phenomena, but in actual fact it is a return to a process of financial intermediation which was commonplace in the late 19th century. In fact, by 1989 the international financial system may have more in common with the world of 1889 than the world of 1979 or 1969.

Between 1870 and 1913, Britain and other European nations exported capital to North America, Australia, India, Africa and Latin America on a scale which has not been surpassed since. By 1913, Britain had external investments equal to nearly 200% of her GNP compared to a peak of only about 8% for the U.S. five years ago and less than 15% for Japan today. While Britain was the dominant creditor power of the period, France, Germany and Holland had large external investments as well. Many American investors also owned foreign securities before 1914, but the U.S. itself did not shift to a net creditor status until the First World War.

As with today's boom in new bond issuance, the primary mechanism for international capital transfers during the late 19th century and early decades of this century was securitized lending or equity purchases, not commercial bank lending. In 1913, for example, British private investors and merchant banks owned nearly 4 billion pounds of foreign bonds while British banks had only 300 million pounds of foreign loans. The growth of commercial banking played an important role in the internal development of many economies during this period, especially Germany and Japan, but international capital flows occurred primarily through bond and equity markets rather than direct lending.

In fact, the enthusiasm for international lending by British and European investers was so great during the years before the First World War that the world came very close to experiencing a major debt crisis. By 1913, the debt/export ratios of many developing countries, including Canada, Australia and South Africa were far higher than the debt/export ratios of many Latin American countries today. Despite these large debt burdens, though, a financial crisis did not occur for three reasons. First, there was not a commodity price collapse after 1913 comparable to the one which occurred during the early 1980's. Instead the supply shocks of World War One pushed up many commodity prices. Secondly, much of the money borrowed during the period 1870-1913 was invested productively, encouraging rapid growth of exports for debt servicing. Thirdly, because most international lending before 1914 took the form of bond sales rather than bank loans, debtor countries had few problems rolling over short-term loans.

As with any market driven phenomena, the international investment boom of the late 19th century and early 20th century was subject to periodic shocks and disruptions. First, monetary tightening in Britain during the early 1870's and 1890's produced sharp declines in capital outflows, which led to severe recessions in debtor countries such as Argentina and Australia. Secondly, British investment in countries such as Argentina was so large that the British government on some occassions intimidated the Argentines into granting preferrential trade rights or profit subsidies to British owned firms operating in the railway and utility industries. Whereas today's foreign investment in third world equity markets is being done primarily through purchases of companies traded on local stock exchanges, much of the British investment in countries such as Argentina before 1914 resulted from the floatation of new companies on the London stock market whose capital was then transferred to Argentina. As a result of this funding process, the Argentines often viewed the companies as British entities operating in Argentina rather than as Argentine companies with a significant foreign shareholding. Thirdly, the French and German governments often used capital outflows as foreign policy tools and attempted to direct lending activity towards countries which were potential military allies, such as Russia. Finally, if a borrower got into financial difficulty, it was more difficult to reschedule bond payments than a bank loan. On the whole, though, historians believe that the tremendous expansion of international investment during the half century before 1914 had a positive influence on economic growth in both capital exporting and importing nations.

World War One interupted the growth of international investing, but it resumed during the 1920's under American leadership. Between 1923 and 1929, U.S. retail investors purchased $6.3 billion of foreign bonds, primarily from issuers in Latin American and central Europe. U.S. commercial banks also played an active role in encouraging international lending, but they were primarily underwriters of foreign debt to the U.S. public. In fact, the Glass-Steagal Act was enacted in part because of public outrage at the First National City Bank of New York for securitizing its bad Peruvian loans and selling them to unsophisticated retail investors shortly before Peru defaulted. In many ways, high yielding South American and central European paper was the 1920's equivalent of today's "junk bond" phenomena.

The Mid-1980's

Today's renewed movement towards globalization of financial markets and securitized lending reflects several different factors.

First, new developments in computer and communications technology have greatly reduced the cost of both international investing and securities trading. It is increasingly easy for firms in different financial centers to communicate with each other. In fact, twenty four hour trading is now becoming so common that the Chicago futures exchanges will soon introduce night-time trading co-incident with Tokyo's operating hours. By 1995, the Wall Street Journal may have to publish two editions per day; one for traders arriving at work at 7 am and the other for traders arriving for work at 7 pm. Computerization, meanwhile, has made it possible for the financial markets to accomodate trading activity in both securities and derivative products on a scale at least ten times greater than in the 1970's and three hundred times greater than in the 1950's.

Secondly, the adverse effects of the debt crisis on U.S. bank share values and the introduction of higher bank capital requirements by regulatory authorities has increased the cost of traditional bank lending at the same time that computerization is lowering the cost of securitized lending. This disadvantage could be corrected through a new regulatory framework which lowers U.S. bank capital requirements but such a development is unlikely to happen in the near future because of the large stock of low quality bank assets left over from previous lending cycles. As Japanese banks enjoy relatively low capital costs, it is possible that there could be a renewed boom in global bank lending originating from Tokyo, but it is doubtful that Japanese banks will attempt to increase their lending activity in Latin America or Africa until the economic environment improves there. They will probably instead attempt to capitalize on the uniquely low cost of bank capital available in the Japanese financial system by increasing their market share in other industrial countries.

Thirdly, the rapid growth of securities markets outside the United States has made global diversification a more attractive option for U.S. investors than it was in the past. In the early 1970's, the U.S. accounted for about 70% of all global stock market capitalization. Today, it accounts for only about 44% of the total. Reflecting her superior economic performance and strong currency, the most rapidly growing foreign equity market in dollar terms during recent years has been Japan's, but there has been a significant expansion of market capitalization in other countries as well.

Fourthly, the tremendous growth of pension funds and other institutional forms of savings has created a market for securitized lending, which is now logically expanding to include foreign bonds and equities. Before the Second World War, the primary market for most securities was individual investors, but in many countries pension funds now account for 20-30% of all savings flows. In 1985, for example, U.S. private pension funds had assets exceeding $1.2 trillion of which about $30 billion was invested offshore. Industry consultants project that total private U.S. pension fund assets will grow to $2 trillion dollars by 1990 and that nearly $100 billion will be invested in foreign markets (public pension funds still tend to restrict foreign investment). Japanese pension fund assets are projected to grow even more rapidly during the next decade and their international exposure is also relatively modest. Among the major industrial nations, only Britain pension funds have foreign assets approaching 20% of the total. If the foreign share of U.S. pension fund assets were to achieve such a level by the late 1990's, the sums involved would probably exceed $500 billion.

Finally, nearly sixty years have passed since the international investment boom of the late 1920's. As a result, folk memories of the risks and dangers of international diversification have faded. Meanwhile, the decline of the dollar has produced a boom in retail demand for internationally oriented mutual funds which is whetting investors' appetites for even more speculative foreign securities. In the past twelve months, Wall Street has floated four new country mutual funds for investing in Korea, Taiwan, India, and Thailand as well as two funds for general investment in a diversified portfolio of developing country equity markets. The collapse of U.S. interest rates also has generated strong American demand for high yield foreign bonds. In the first half of 1986, for example, U.S. investors bought nearly $6 billion of Australian bonds through a combination of mutual funds sales and direct purchases. Given the increasing similarities between Australia's balance of payments and Latin America's during the late 1970's, the strong demand for Australian bonds suggests that some developing counties could also tap the U.S. junk bond market with issues of either straight debt or bonds with an equity conversion feature.

The Future

The recent boomlet in mutual funds targeted at developing country equity markets creates an opportunity for both attracting new capital to those countries as well as for improving the quality of their external financing mix compared to overwhelming dependence on bank lending which occurred during the 1970's. The stock markets of the developing countries are not yet large enough to provide an equity financing solution to the debt crisis, but they could still make a useful contribution towards encouraging future resource transfers and improving the prospects for world economic growth. How big could this contribution be? The outcome will be conditional upon the answers to three other questions.

First, how much money is available for investment in the security markets of non-industrial countries?

Secondly, how much money could these emerging equity markets realistically absorb given the fact that they are still relatively undeveloped and subject to less stringent regulatory requirements than the stock exchanges of the U.S., Britain, and other industrial countries?

Thirdly, what kind of investment vehicles could be created to accelerate the flow of foreign equity investment to the developing countries without generating political alarm in the recipient country about loss of local control over the economy?

The answer to the first question is largely open ended and dependent upon investment opportunities. The developing country equity mutual funds floated in the U.S. during the past year raised less than a billion dollars in aggregate and were targeted on the most successful countries in the group. Hence, they cannot compensate for the decline of non-OPEC LDC bank lending from $30-35 billion before 1982 to $15 billion per annum recently. But three factors suggest that it would be easy to launch several more mutual funds and attract much larger sums. First, both the Korean and Taiwanese mutual funds were oversubscribed and are now selling at large premiums to asset values. The premium indicates that the amount of money available for investment in those countries greatly exceedes the supply of securities now available to foreign investors. Secondly, the recently floated Templeton Emerging Markets Fund, which can invest anywhere in the third world, also was heavily oversubscribed. Thirdly, the above mentioned funds were sold only in the U.S. and Britain. The world's largest capital exporters are now Japan and Germany. As the supply of surplus liquidity there vastly exceeds that in the U.S. and Britain, it should ultimately be possible to attract more funds from Tokyo and Frankfurt than from New York and London. While there is no precise way to quantify the demand for a new financial product until it actually appears in the marketplace, the success of the new country funds suggests that there is potentially several billion dollars available from the U.S., Japan and Europe for investment in the developing country market equity markets if an adequate supply of paper is offered for sale.

The major problem with encouraging greater bond or equity investment in the developing countries is finding a sufficient supply of securities to purchase. The fifteen largest developing country stock markets have enjoyed good growth during recent years, but their aggregate capitalization is still less than $140 billion. The largest is Brazil, with a capitalization of nearly $45 billion. Next are several middle tier Asian markets, including Malaysia and Singapore with $30 billion of capitalization, India with $20 billion, Taiwan with $13 billion and Korea with

$12 billion. Unfortunately, the capitalization of the Mexican market is only about $6-7 billion while Argentina's market is worth just $2 billion. There are a few markets in Africa, but the only one with a large capitalization is Johannesburg. The Lagos, Nigeria market had a capitalization of over $2 billion in 1983, when oil prices were higher, while Nairobi and Harare (formerly Salisbury, Rhodesia) have capitalizations of $200-300 million and would be overwhelmed by orders in excess of one million dollars.

The small size of the developing country equity markets reflects several different factors. First, large businesses tend to be more family oriented in the developing countries than in the industrial countries. Secondly, accounting and disclosure standards are less stringent, so many investors do not regard equities as a safe investment unless they have ties to the controlling family itself. Thirdly, large corporations are often under government control and hence obtain their capital solely through debt sales or taxation. Fourthly, the political authorities in many developing countries tend to regard stock markets as casinos rather than as potentially useful forms of financial intermediation for encouraging economic development.

These factors are not insurmountable barriers, though. The capitalization of the Singapore/Malaysia equity markets are now equal to nearly 63% of those countries' GNP compared to less than 20% in most other developing countries. There has been a significant flow of foreign equity investment to markets such as Hong Kong and New Zealand during recent years despite the fact that both countries tolerate very permissive accounting standards and have an erratic history of policing self-dealing by company managements.

In some countries, stock markets used to be important sources of capital, but have since shrunk because of economic policies hostile to private investors. The best example of such a transformation is probably Argentina, which ranked sixth in world per capita income during the 1920's and enjoyed a vibrant stock market with large foreign participation before World War Two. In fact, Argentina was such an important market fifty years ago that the New York Times Business Section still publishes a quaint assortment of Buenos Aires stock quotes each day while ignoring the far larger markets of Brazil, Korea, Taiwan and Singapore. Once a country has had a stock market, though, there is at least some financial infrastructure available for reigniting interest in equity investment there. Indeed, the most interesting experiment in the revival of moribound stock markets today is the plan by several state companies in the People's Republic of China to sell shares to private investors and then to permit trading in them on newly opened local stock markets.

Need for New Policies

Given the widespread interest now apparent in developing country mutual funds, the major barriers to expanding equity investment in Asia, Latin America, and Africa are probably more internal than external. If the developing countries wanted to attract more foreign equity investment, they could easily do so by (a) encouraging more of their private companies to go public through improved tax treatment of dividends and capital gains (b) privatizing nationalized industries (c) creating effective stock market regulatory agencies as well as more reliable public accounting standards and (d) relaxing retrictions on foreign investment in domestic companies.

Chart Three illustrates the extraordinary potential which now exists for expanding equity investment in the developing counties through accelerated development of local stock markets. At present, the fifteen developing countries in our sample have an aggregate capialization of just under $140 billion, which is equal to about 12.5% of their GNP. If they could expand this ratio to 25% between now and 1992 against a background of only 6% growth in their nominal dollar GNP, the total value of their market capitalization would approach $400 billion.

How realistic is such an estimate? If the developing countries make a serious effort to expand their stock markets, it probably understates the potential growth. Between 1980 and 1986, the stock market capitalization of the world's fourteen largest industrial countries grew from $2.2 trillion to $5.6 trillion. During the same period, the stock market capitalizations of several Asian developing countries more than quadrupled while Brazil's doubled. Since the developing countries have higher potential growth rates than the mature economies of North America, Japan and Europe, the value of their stock market capitalizations should increase far more rapidly than those of the industrial countries under policies designed to promote equity capital formation. The major challenge will be to encourage a broad based growth of third world stock market capitalization during the next decade. If current economic trends persist, the total capitalization of the fifteen countries in our sample could well reach $400 billion by the early 1990's, but there is a significant risk that most of the growth will occur in fewer than half of the countries, including those which now export capital, such as Taiwan and Singapore.

While the development of equity markets is a theoretically attractive way to diversify a country's sources of capital, there is considerable resistance in some countries to expanding stock markets and using them as a vehicle to attract foreign savings. First, nationalized industries are often a source of patronage and hence political power, especially in the Latin American countries. Secondly, the governments of many developing countries still associate foreign ownership with loss of control over the economy and thus prefer external borrowing to foreign equity investment in local companies. This attitude is not unique to the developing countries. The U.S. itself has restrictions on foreign purchases of television stations and defence contractors while a few American policians favor the imposition of even stronger controls on Japanese purchases of American assets today. But fear of foreign domination is a far greater problem in countries whose total GNP's are smaller in size than the portfolios of many U.S mutual fund management companies. Thirdly, money center banks were so indiscriminate in their willingness to provide credit during the 1970's that many third world countries have had little incentive in the past to develop more diversified sources of capital. In fact, some foreign stock markets did a better job of screening risk during the 1970's than the money center banks. Fifteen year ago, for example, the Phillippines had one of the largest stock markets in Asia, but it shrank steadily during the final years of the Marcos regime because of the deteriorating performance of the economy and outright theft of many companies' assets by Marcos cronies. If bankers in New York and elsewhere had paid more attention to the local stock market as a barometer of business confidence, they probably would have made far fewer loans to the Phillippines.

While fear of foreign control is a contentious political issue in several developing countries, there are mechanisms available for liberalizing investment guidelines without losing control of the economy. Instead of permitting completely open access to their stock markets, developing countries could permit gradual liberalization through the creation of mutual funds specially targeted at foreign investors while introducing official ceilings on the level of foreign ownership of strategic industries. Japan permitted the creation of such mutual funds in the 1960's before opening its market to direct foreign equity purchases. A similar process of controlled liberalization is now underway in Korea and Taiwan. Brazil attempted to follow the Japanese model in the early 1970's, but the development of its stock market was then retarded by the oil price shocks of 1973-1974. Plans are now underway, though, to resume the process through the floatation of a new mutual fund for offshore investors. Singapore, meanwhile, permits foreign investors to purchase any of its equities, but has a 20% foreign ownership ceiling on economically sensitive companies, such as Singapore Airlines. Despite its emergence as a major power, Japan also retains similar ownership thresholds on several of its companies.

In short, there are a variety of options available for addressing political concerns about loss of control over national sovereignty while also providing foreign investors with vehicles for making equity investments. In each case, several technical questions will have to be addressed. Is the board of the new mutual fund dominated by inside or outside directors? How are management fees allocated between local advisors in the country and the parent sponsor in New York, London, or Tokyo? What restrictions will there be on the speed at which capital can be repatriated if a foreign stock market starts to deteriorate? As the marketing success of the new funds will testify, though, these technical questions are not insurmountable barriers if the potential host country actually wants to create an attractive regulatory climate for foreign investors.

If we apply an across the board 20% ownership restriction on the $400 billion of equity capitalization which could be available in the early 1990's under policies designed to achieve a 25% stock market/GNP ratio, the equity markets of the developing countries would be able to absorb up to $80 billion of foreign owned investment without jeopradizing local control of the economy. An $80 billion foreign owned equity portfolio in 1992 also would represent only about 5% of the GNP of the fifteen developing countries in our sample compared to U.S. external borrowing and asset sales to foreigners approaching 4% of GNP today.

In addition to the creation of more mutual funds for encouraging third world equity investment, recent events suggest there would probably also be strong demand in New York, London and Tokyo for alternative hybrid instruments, such as convertible debt or bonds with equity warrants. Because of official retrictions on foreign purchases of Korean stocks, for example, there has been strong demand in London for Korean Eurobonds, which can be converted into equity at some point in the future. If other countries are still uncomfortable about rapid growth of direct foreign investment in their equity markets, they could probably duplicate the Korean experience by letting their firms sell offshore debt with an equity conversion or warrant feature. Obvious candidates for such hybrid instruments would include countries highly sensitive to the question of foreign ownership, such as Brazil, India and Mexico. Hybrid debt/equity issues might also be denominated in a variety of foreign currencies, not just U.S. dollars, so as to widen the investment appeal of the instrument and limit the borrower's currency risk before conversion to equity occurs.

Another potentially interesting concept for encouraging third world investment is the debt/equity swap. Only three countries -- Mexico, Chile, the Philippines -- currently permit them but they could be useful in a wide range of circumstances. Under a debt/equity swap, a company would purchase a bank's dollar denominated Mexican loan at some discount to book value (currently about 30-40%) and then convert it into Mexican pesos with the local central bank at yet another discount (usually 10-20%) for investment in its Mexican subsidiaries or the purchase of other Mexican assets. Such swaps have three major advantages. First, they permit banks to get rid of external loans which exceed their current portfolio target? Secondly, the swap permits companies to obtain foreign currency at a deep discount from market prices? Thirdly, the transaction reduces a country's external dollar debt without generating a major capital outflow?

The idea is not without risks. If the swaps were to occur on a large scale, they could, in theory, jeopardize monetary control in countries such as Mexico by encouraging the creation of too many new pesos through dollar conversion operations. So far, though, swap activity has been averging only about $5 billion per annum, or a modest sum compared to Latin America's $350 billion of external debt. The potential advantages of increased swap activity also greatly outweigh the monetary control risks. First, they will permit banks to write down third world paper on the basis of market prices at a speed consistent with their other financial objectives. Hence, banks could match losses on loan sales with windfall profits from other operations in order to smooth out the earnings effect. Secondly, the swaps will encourage reinvestment of the discounted loan proceeds in potentially productive enterprises. In the 1970's, by contrast, U.S. banks made open-ended loans to Latin America which frequently ended up financing capital flight or wasteful investment by nationalized industries.

There is already one Mexico oriented mutual fund on the U.S. stock market but it sells at a 20-30% discount from asset value. One way to accelerate the development of the debt/equity swap concept would be to create three new funds for American, Japanese, and European investors, which would purchase bank loans at a discount, sell them to the central bank for Pesos, and invest the proceeds in a diversified portfolio of Mexican equities. Under such a set of swap transactions, investors would be able to obtain a portfolio of Mexican securities at a discount to market and thus be able to avoid the risk of the fund's value falling to a large discount shortly after its floatation. By offering a series of swap driven funds in three different markets, there also would be less concern in Mexico about the transactions producing a significant increase in American control over the economy. Indeed, if the swap discounts were large enough, it might even be possible to tempt some wealthy Mexican investors to redeploy in their own country some of the tens of billions of dollars which they currently hold offshore.

The Economic Adjustment Ahead

The stock markets of the major industrial countries are now in the midst of one of the greatest bull markets in modern history. The Dow Jones Industrial Index has nearly tripled since 1982; U.S. stock brokerage commissions as a share of GNP are at levels last seen during the boom of 1929; the equity markets of Britain, Japan, France, Hong Kong, Australia and many other countries are also at record levels.

The boom in world equity markets reflects several different factors; the expansionary thrust of monetary policy in the industrial countries, a worldwide shift towards tax policies more favorable to savings and investment, privatization of nationalized industries in some countries, and the benign effects of falling inflation on the demand for financial assets generally. In the 1970's, individual investors were attracted to inflation hedge asset such as real estate and commodities. In the monetary crunch of the early 1980's, they shifted over to highly liquid forms of savings, such as money market funds. Now private investors are desperately trying to protect portfolio yields in the face of falling interest rates by switching to equities and bonds.

The challenge today is to find new ways for accelerating the developing countries' participation in the world's securitized lending and equity investment boom. The marketplace itself could do the job over time without any institutional reform or special assistance simply because investors themselves will search for higher returns in developing country equity markets as returns on conventional securities decline further. British private investors created investment trusts to purchase American railway bonds during the 19th century because of the low yields then available on British government debt. In 1986, American investors turned to the Australian bond market for higher yields because the return on U.S. bonds had fallen to 7-8% from double digit levels during the first half of the decade. Today, many global fund managers are gobbling up any equity which comes to market from Korea or Taiwan because they perceive the yield on Japanese securities to be too low. The pricing mechanism for risk and return does work if money is allowed to search for the highest yield.

The problem with such a passive market-driven solution to the developing countries' capital needs is that the world financial system is not a level playing field. There is a tremendous asymetry in the responsiveness of different national economies to monetary stimulus and their ability to import capital when excess liquidity accumulates elsewhere in the system. The financial institutions of the U.S., Britain, and other Anglo-Saxon societies are very aggressive and thus respond quickly to falling interest rates; the financial systems of Japan and some continental European countries are highly regulated and thus respond very slowly to changes in borrowing costs. In the 1970's, this asymetry did not matter because accomodative monetary policy in the U.S. helped to boost American exports, not just imports, by encouraging a large rise in bank lending to many developing countries. Since 1982, though, bank lending to most developing countries has ceased and thus choked off one of the channels through which American monetary policy previously stimulated important U.S. export markets.

This asymetry in the international system's responsiveness to monetary stimulus poses a major dilemma for the Federal Reserve. It could require the Fed to pursue a highly permissive monetary policy simply to sustain modest growth in the world economy. Under such circumstances, stock market speculation and debt usage in the U.S., Britain, and other Anglo-Saxon societies with liberal financial systems could rise to dangerous levels before financial asset yields fall far enough to produce a major revival of capital flows to the developing countries. The market would ultimately clear in favor of the developing countries, but at a high risk to world financial stability.

As the recent collapse of money turnover ratios in practically all the industrial countries will testify, restrictive money supply targets have ceased to be a constraint on economic growth. The world financial system is now awash with liquidity; the bottleneck in the system is not the supply of money but its distribution. In Japan, households do not yet have easy access to the surplus liquidity of the corporate sector. In the world economy, many developing countries have lost access to the excess savings of the industrial nations. Hence, a few countries are being forced to do the borrowing and spending which was formerly done by many. In the 1970's, the international banking system helped to prevent two oil price shocks from causing a protracted world slump by recycling the surplus savings of OPEC to South America. In the 1980's, the international financial system has again prevented a depression by recycling the surplus savings of Europe and Japan to North America. In the short-term, this process is benign for the living standards of the countries doing the borrowing and spending, such as the U.S. between 1982 and 1986, but in the long-term it has the potential to create highly destabilizing financial imbalances. Indeed, many U.S.banks are now rushing to generate income from high risk domestic loans in order to offset losses from the bad loans of the 1970's.

The risks of both trade wars and speculative mania in the financial markets would diminish if policies could be designed to increase the developing countries' access to the surplus liquidity now fueling stock market and property booms throughout the industrial world. Although the initial sums likely to result from such an effort would be modest compared to the the bank lending of the 1970's, they would still generate momentum for institutional reform in the developing countries which could become self-perpetuating over time. Indeed, past history suggests that the sheer prescence of more foreign investors in an emerging equity market would itself be a catalyst for new company floatations, more rapid privatization of nationalized industries, and general improvement of corporate disclosure standards. As the process of financial evolution accelerated during the 1990's, today's 400-500 million of foreign investment in the world's emerging equity markets could expand into sums ten or twenty times larger and provide a more diversified and enduring source of private capital for southern hemisphere economic development than has been available at any time since 1914.

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LATIN AMERICAN EXTERNAL DEBT AND NATURAL RESOURCES CONSERVATION

BY BARBARA J. BRAMBLE, DIRECTOR
NATIONAL WILDLIFE FEDERATION

BEFORE THE SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON INTERNATIONAL DEBT

APRIL 6, 1987

I am submitting this statement on behalf of the National Wildlife Federation, the largest citizen conservation organization in the free world. The Federation and its 4.6 million members and supporters are dedicated to the wise use and management of natural resources, and we believe that these form the underpinning of sustainable economic development.

In many developing nations today, the prospects for achieving sustainable development are threatened by several factors, including high rates of population growth, which exacerbate, and are also caused by, severe poverty and a deteriorating natural resource base. Superimposed upon this vicious circle of poverty and environmental degradation in most developing countries is an enormous external debt which is not only inhibiting their economic growth, but has thrown many of their economies into reverse, reducing the already low standard of living of their citizens.

In your previous hearing you discussed the history and causes of the Third World debt crisis. I intend to concentrate on the environmental dimensions of this crisis.

Introduction

The external debt of Third World nations is approaching a total of $1 trillion. A significant portion of this sum is owed by a few major economies, for the most part in Latin America. Another group of 40-50 countries, many in Africa, have external debts that are not large enough to precipitate a world financial crisis, but are enormous in relation to their gross national products. Presently, many countries are straining to repay their debts and a few have either given up entirely or restricted their interest payments. An international economic crisis is brewing which could explode within the next year if the larger debtor economies find continued debt service impossible.

Conventional wisdom calls for export-led growth to resolve the debt crisis. In the United States, the recently-announced Baker Plan (named after Treasury Secretary James Baker, III), to pump $29 billion in new loans into the economies of some of the largest debtors, is the current prescription offered by the Reagan Administration. The International Monetary Fund (IMF) has consistently pushed one strategy across-the-board -- increase exports, decrease imports, and cut domestic government spending -- including (or especially) social programs. Imposition of these standard IMF conditions is a prerequisite for new or rolled-over loans, which in many cases are used just to pay interest. The imposed austerity program often results in reduced domestic industrial and food production capacity, reduced health and nutritional status of the poor, and higher unemployment.

Because of this emphasis on promoting exports, particularly cash crop monocultures, to service the debt, many economically depressed Third World countries are forced to place growing pressures on their overstressed ecosystems, such as marginal farmlands and genetically rich tropical forests. Mexico is mining the groundwater of its northern tier states to produce vegetables for the U.S. market. Irrigation pumping will only be economically viable for a few more years. Thus, the need to increase short-term economic productivity is, in many cases, reducing the potential for long-term sustainable development in agriculture, forestry, and fisheries.

Present lending conditions also require deep government spending cuts, thereby crippling forest, water, and land management agencies. Brazil's promised forest management plan to reduce destruction of the valuable Amazon tropical lowlands cannot be implemented, due to a personnel freeze. Governments are also cutting environmental protection programs, and delaying the delivery of health and sanitation services, which increases health costs and reduces the productivity of workers.

Because the short-term measures may often be counter-productive, it may not be possible for deeply indebted nations to "grow" their way out of the debt crisis. But this tragic situation may nevertheless present an opportunity to open up the closed international banking system to some public scrutiny. In this context, non-governmental organizations (NGOs) in both debtor and creditor countries are proposing new approaches to the crisis which might (a) reduce the destructive effects of conventional lending conditionality on natural resources in borrowing countries, and perhaps (b) make some funds available for beneficial programs to promote sustainable development.

Timeliness of Such Proposals

This seems a particularly opportune time to present proposals that offer alternatives to conventional development lending:

* Thoughtful economists, government officials, and commercial bankers, among others, now admit that the debt crisis is worse than it appeared when it hit the headlines in 1982 and the conventional solutions have proven inadequate.

* The Baker initiative, whatever its faults, has served to open the field to new ideas, because of its implicit concession that the traditional medicine is not working. The Baker proposal will be under heavy scrutiny in 1986.

* The United States Senate soon will be considering a Bipartisan Trade Bill which, among other things, will set Congressional objectives for a new round of global trade talks and will probably encourage added World Bank and commercial bank financing to Third World countries that agree to remove trade barriers.

- There will be a new round of General Agreement on Tariffs and Trade (GATT) negotiations in 1986.
- NGOs from both northern and southern countries are increasingly concerned about the effects of IMF conditionality, and multilateral development bank (MDB) projects and policy influence, on the potential for long-term sustainable development in the Third World. Over the last three years, a campaign by environmental groups from several countries, to improve the environmental performance of the MDBs, has received increasing attention, particularly in the United States. This work culminated in U.S. legislation adopted in December, directing the Treasury Department to take specific measures in this regard.

There may soon come a time when the lending community, both commercial and official, realizes (or is forced to realize) that good money can not continue to be thrown after bad. New debt relief schemes will be proposed, and conditions and concessions will be negotiated among governments of creditor and debtor countries, as well as multilateral agencies and the private banks. If that point is reached, all parties to the negotiations must share some of the losses in order to permit a new beginning for the borrowers on a more promising, sustainable economic footing.

The alternative to this scenario could well be massive debt repudiation or default, trade breakdown, and worldwide recession or worse. When the debt crisis reaches a critical stage, there will be an opportunity within the ensuing public debate for well-thought-out alternative solutions to receive appropriate attention and to be incorporated into new international financial arrangements. In this way, the debt crisis might prove a vehicle for positive, long-term economic change--the kind of change that will not waste the world's resource base, or its potential for sustainable development.

New Conceptual Approaches to the Debt Crisis

To complement several new conceptual approaches to the debt,*/ conservationists offer the following proposals as relevant to the possibility of future sustainable development:

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*/ See Cavanagh, John, Fantu Cheru, Carole Collins, Cameron Duncan, and Dominic Ntube, From Debt to Development: Alternatives to the International Debt Crisis, Institute for Policy Studies, Washington, D.C., 1985; DeCoodt, Patrick, "The Third World Foreign Debt Problem: Whose Problem? Which Solutions?" in Revue de la Banque, Centre de'Etudes Financieres, Brussels, Belgium, 1985; Alfred J. Watkins, 'Til Debt Do Us Part, Roosevelt Center for American Policy Studies, Washington, D.C., 1986.

I. Significant Modifications in IMF/MDB Loan Conditionality

Many borrowing nations, particularly the large economies of several Latin American nations, will continue to seek access to external funds. Co-financing by commercial and official sources will be common. Some form of conditionality inevitably will be negotiated as a quid pro quo for new loans and rollovers.

Public interest NGOs, working in both borrowing and lending countries, are examining the effects of standard austerity conditions on nutrition, human health, and natural resources. These groups can ask their governments to seek modifications in those conditions that appear counterproductive for long-term development. This avenue may be particularly fruitful where public agencies or the taxpayers in the lending nations are asked to guarantee new loans.

The following section enumerates a few examples of needed modifications in conditionality which relate specifically to conserving the productive natural resource base.

A. Exceptions to Austerity Programs

1. Along with basic nutrition, health, and education, several kinds of natural resources programs should be exempted from austerity program budget-cutting. They can be viewed as investments in future development, and as elements of national security. Among these are:

a) forest and watershed management

b) estuarine and coastal fisheries management

c) agriculture research and extension for domestic food production, particularly low capital input systems for small farmers

d) energy conservation investments

e) soil conservation programs

f) reforestation programs

g) establishment of high-priority reserves for biological diversity conservation

2. Similarly, certain health and environmental protection programs should be exempted from austerity cuts because they increase the productivity of workers, and/or offer significant economic savings over time. These would include:

a) toxic contamination prevention

b) basic air and water pollution equipment for new installations where retrofitting would be more expensive

c) provision of sanitary water supplies

d) sewerage systems in urban areas

3. Where a country has undertaken land tenure reform, titling or redistribution programs, full funding should be continued even under austerity requirements. Such programs can relieve pressure on marginal lands and give new landowners a stake in practicing sustainable agriculture.

4. Although in general, the elimination of subsidies promotes more efficient use of resources, under certain circumstances a subsidy may serve to discourage the overexploitation of a scarce commodity. One example is a hydrocarbon fuel subsidy where firewood scarcity is severe. Short-term continuation of the subsidy may be needed until fuelwood plantations are started; it can be phased out as firewood becomes available. By contrast, a sudden cut could lead to severe degradation of existing marginal woodlands, long-term erosion and loss of soil productivity.

B. Conditions to Foster Sustainable Resource Use or Avoid Export-Led Environmental Disasters

1. Loans to the energy sector should be predicated on sound conservation investments where feasible; and funds for hydroelectric dam construction should be conditioned on implementation of watershed management plans to protect the generating capacity of reservoirs.

2. Timber development concessions should be viewed as long-term investments, and conditioned on requirements for replanting of appropriate species.

3. Instead of imposing across-the-board export incentive policies for short-term gain, incentives should be crafted to avoid long-term costs such as:

a) destruction or degradation of tropical forests or other marginal lands to open up poor-quality, short-term pasturage for beef cattle

b) harvesting of endangered or threatened species of plants or animals

c) building roads to open up expanses of pristine tropical forest before sustainable uses are developed for the land

d) displacement of small farmers and indigenous peoples

e) encouraging cash crop expansion for crops already in oversupply (currently sugar, cotton, rubber, and tobacco) thus causing farmers to earn lower returns on land that could be put to better use, and simultaneously adding to pressure on marginal lands for food production.

II. Variations of Debt Forgiveness or Conversion to Local Currency Obligations

For nations with a debt large in proportion to their economies, changes in loan conditionality will not be sufficient. Some form of interest-rate reduction, debt forgiveness and/or conversion will likely prove necessary; this is particularly true of the nations of sub-Saharan Africa.

Naturally, commercial banks have little incentive to reduce or write-off outstanding loans, except in the interest of preserving international financial stability. Thus the debt forgiveness/conversion proposals have more immediate application to countries where a significant portion of the outstanding debt is owed to official lenders. Nevertheless, it remains a possibility that commercial banks may have to be included in overall negotiations at some point, to share the losses, along with governments and taxpayers, if a big borrower faces actual default.

It is probable that a negotiated settlement in which a quid pro quo is offered by each party, would be a more satisfactory resolution than total default by a borrower. Taxpayers of the lender nations could more likely be persuaded to accept the necessity of paying a portion toward debt forgiveness or conversion, if it meant the borrowing countries would thereby gain long-term enhancement of development prospects, and if any private banks involved would be foregoing their fair share of expected profit as well.

Three, among many possible forms of debt forgiveness or conversion, are noted.

A. "Conservation Credits" Against External Debt

This would be an agreement tailored for each country in which lenders would reduce interest rates, or forgive outright old debt, in return for the borrower's implementation of an appropriate set of new or increased programs in soil conservation, watershed protection, fisheries or forestry management, small farmer agriculture, biological diversity protection, etc. In essence, dollars owed would be converted to local currency earmarked for natural resources projects.

Some of the agreed-upon conservation programs would involve significant local currency expenditures for personnel and equipment to be credited against the debt. But others would be "payments-in-kind" whose value would greatly outweigh any actual monetary expenditure. These would have to be valued appropriately. Examples of possible "payments-in-kind" would be:

- collection, conservation, and reproduction of genetic species and varieties of plants and animals;
- reforestation and afforestation with local varieties or appropriate imported varieties of trees and shrubs;
- collection and recording of traditional agricultural, medical, nutritional, and pharmaceutical knowledge; establishment of scientific institutes to examine and upgrade this knowledge;
- the creation of national parks and biological diversity reserves.

The eligible programs would be proposed by the borrowing country, as part of their application for debt relief, and negotiated with the lenders and creditor governments. Credit would be calculated using some multiple of the local costs of the resource programs (double, triple or more, as appropriate). Mechanisms would be put in place to assure implementation of their obligations by all parties.

B. Local Currency Accounts

Another form of the same idea would involve a more explicit conversion of external debt to local currency. It would be particularly appropriate for countries with a high proportion of private commercial bank loans. By agreement among the banks, the borrowing and principal creditor country governments, and the IMF, the interest due would be divided into 2 parts: one portion, that which is agreed to be a manageable payment by the borrower, would be paid regularly when due, in dollars. The rest of the interest would be paid as it accrues, into a special local currency account in the national bank of the borrower which would be restricted for use in agreed-upon projects to encourage sustainable development.

The creditor banks, as well as local investors, would be permitted to invest these funds in projects which meet the negotiated conditions. If the foreign banks chose not to reinvest the accumulated unpaid interest directly themselves, these funds would not be totally lost, but would remain in restricted accounts accruing additional interest in local currency. But either way the interest payments would be made available for productive investment in the borrowing country.

Care would be required in these negotiations to (1) clarify that natural resources management programs qualify as appropriate investments, and (2) define the parameters of sustainable development to avoid funding more short-term projects which degrade the long-term productivity of natural resources.

C. Regional Fund

Negotiations could take place among borrowers and lenders on a regional basis, to set up a regional restricted local currency fund into which part or all of the amounts of external debt of several countries would be paid -- as a paper transaction. Each country would then apply to the fund for the use of its share in the form of local currency expenditures on its own local natural resource programs. The fund could be set up within a new institution or an existing body such as IFAD.

The eligible programs would be the same as those described above in A. The fund would be managed by a board composed of borrowers and lenders; the fund would have some role in monitoring and approving projects.

Conclusion

The foregoing proposals and recommendations certainly are not exhaustive in their depth or scope. We hope they will serve as a catalyst for further discussion and follow-up. We recognize that there are large debtors and small debtors in various degrees of economic difficulty; thus, certain proposals that have been suggested will work for some countries or regions and not for others. Regarding some countries in Africa, for example, it may be desirable to freeze all payment obligations immediately, to gain a breathing space to negotiate an appropriate relief package. But one purpose of this memorandum is to emphasize that the economic and resource security of much of the world must not be left to government officials and bankers alone. This is the public's business.

STATEMENT
# of the
UNITED STATES COUNCIL
FOR INTERNATIONAL BUSINESS

on

RECOMMENDATIONS TO THE SENATE ON THE INTERNATIONAL DEBT CRISIS

APRIL 28, 1987

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U.S. COUNCIL FOR INTERNATIONAL FOR BUSINESS

RECOMMENDATIONS TO THE SENATE ON THE INTERNATIONAL DEBT CRISIS

The United States Council for International Business represents American Business in the major international economic institutions. Its primary objective is to promote an open system of world trade, finance and investment. Through its affiliation with the Business and Industry Advisory Committee to the Organization for Economic Cooperation and Development, the International Organization of Employers, and the International Chamber of Commerce, the Council officially participates in the work of the OECD, the International Labor Organization, and the United Nations system, including related international agencies. The U.S. Council, through its affiliation with the ICC, consults with the GATT organization as well as with the Ambassadors representing the Contracting Parties.

We reconfirm our belief that the best strategy for fostering world economic growth, especially in the developing countries, is to adupt a three pronged approach to: 1. boost growth in the industrial countries while keeping import markets open; 2. make additional finance available to developing countries from multinational institutions, commercial banks and multinational enterprises in order to foster additional investment and, therefore, growth; 3. adopt in developing countries appropriate economic and financial policies, under the collaborative guidance of the World Bank and IMF, to help ensure that new finance promotes additional domestic investment and is not consumed or invested abroad.

I. Role of Multilateral Institutions

We support the broad outline of IMF policies, believing that they establish the proper macroeconomic environment for rapid and sustained economic growth. In order for IMF policies to be effective it it imperative that:

- foreign exchange rates not be allowed to become overvalued, thus discouraging exports and aiding imports;

- budgets should not be in large deficit, as that increases the cost of credit to the private sector and threatens to cause inflation whenever monetized by central banks; and that

- interest rates should be close to the rate of inflation. This will ensure that sufficient domestic savings are generated and neither excess nor insufficient credit is extended.

As important as these policies are, it must also be stressed that the business community requires a stable environment if it is to have confidence to invest for the long run.

The World Bank should play a larger role in helping countries develop economic policies. It is not enough to complete a project, if that project depends on subsidized, allocated credits or import protection in order to survive. The World Bank should work to:

- reduce government participation in economic affairs, allowing the private sector to run industry;
- avoid protectionism and instill an outward-looking export orientation;
- eliminate allocated and subsidized credit systems; and to
- coordinate views with the IMF. Joint IMF-World Bank missions should participate in Article 4 consultations.

2. Role of the International Financial Community

Any strategy for growth should provide more resources for new productive investment. The U.S. Government should not legislate debt relief pursuant to an arbitrary mathematical formula. A formula imposing interest rate reduction by 3 percentage points below LIBOR and mandating a write-off of 3 percent annually for three years would in the case of the U.S.only save the debtor countries $3.3 billion in interest payments per year on the $80 billion of claims by U.S. banks. Some have suggested that debt relief will expand U.S. exports. Of the $3.3 billion no more than a third is likely to be spent on U.S. goods based on past trade patterns. In other words, only $1 billion would be gained in U.S. exports compared to the $170 billion trade deficit last year. The export gain could be even less if the debtor countries chose to bolster their reserves. Since debt relief would bring the U.S. and other countries such little reward while damaging the U.S. financial community directly and relative to our foreign competitors, this approach is counter-productive.

To maintain international liquidity and facilitate economic adjustment to the debt burden, the United States Council for International Business suggests that:

- Commercial banks participate in global financing packages when of policies of debtor countries have been approved by the World Bank and the IMF;

- The World Bank stand ready to increase the amount of funding that it makes available to developing countries when its own and IMF conditions are met. Member governments should support a capital increase for the World Bank.

- Consideration should be given to another allocation of SDRs to be made by the IMF. Consideration should also be given to a distribution formula that favors the developing countries. This would directly improve the liquidity of the debtor countries, enabling them to import more while continuing to service their debt. It would be hard to argue that this would be inflationary, at a time when the world has so much excess capacity and commodity prices remain so low.

- Consideration be given to the creation of a special interest rate facility be created at the IMF, analogous to the IMF's oil facility, to help cushion future interest rate shocks.

- A market to swap debt for equity in enterprises in developing countries be encouraged as a way of reducing debt levels and increasing private sector participation in economic activity. However, this should neither be forced on the banks nor on the developing countries.

- All countries should take the necessary domestic legislative action to permit early ratification and implementation of the agreement establishing the Multilateral Investment Guaranty Agency of the World Bank. The Agency, and the bilateral investment agreements to be negotiated under its auspices, will help to improve the climate for the increased international direct investment which debtor countries need as an alternative to continued excessive reliance on commercial bank debt.

- The major creditor countries of the world which have large current account surpluses (principally Japan, Germany, Taiwan, Switzerland and the Netherlands but not the U.S.) take steps to channel finance directly to debtor countries and increase imports from them. This is the international responsibility of creditor countries. It might also have the indirect effect of helping reduce the U.S. balance of trade.

- Seek to improve the institutional framework for influencing domestic policies in the developing countries in the direction of sound private-sector led growth that will provide the necessary climate of confidence for foreign and domestic investment.

These measures, undertaken by the industrial and developing countries, would reinforce the ability of the international financial community to respond effectively to the international debt crisis.

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